

The logo for Sovereign, featuring the word "SOVEREIGN" in white, uppercase letters on a black rectangular background with a red horizontal bar at the bottom.

SOVEREIGN™

2017 EDITION

A panoramic view of the Shanghai skyline, featuring the Oriental Pearl Tower and the Shanghai Tower, with a yellow color overlay.

**CHINA
MARKET
ENTRY
HANDBOOK**



SOVEREIGN CHINA

Sovereign China is part of Sovereign (www.SovereignGroup.com), one of the largest independent corporate and trust service providers in the world. Sovereign currently manages over 20,000 structures for a wide variety of clients – companies, entrepreneurs, private investors or high net worth individuals and their families – and has assets under administration in excess of US\$10 billion. Our comprehensive service offering is structured around three core segments:

- Corporate Services – company formation and management across all major jurisdictions, together with the necessary support to assist companies of all sizes to establish and sustain operations successfully in foreign markets.
- Family Office Services – providing trustee services and wealth management and succession planning to internationally mobile families and entrepreneurs, together with the specialist support needed to secure current goals and long-term sustainability.
- Retirement Planning – providing and administering market-leading international pension schemes that offer choice, transparency and portability across multiple jurisdictions.

With offices in Shanghai and Beijing, Sovereign China (www.sovereigngroup.com/China) accelerates international clients' ability to understand and operate in the China market, and has successfully assisted more than 700 companies from over 50 countries with their China market entry and operational activities.

Sovereign China provides a suite of services designed to lead foreign investors through the market entry process and stay with them to develop long-term success in China. From assisting with understanding the market, developing a market entry strategy to establishing their operations and finally providing back office and compliance support services, we are with our clients from planning through to execution.

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1. A CONVERSATION ABOUT CHINA

WHAT ASPECTS OF THE CHINA MARKET DO I NEED TO BE AWARE OF?

There are several generalities in respect to China that will have an impact on most industries. These include, but are not limited to:

- i. **Geography and population:** With a landmass that is roughly the size of the United States, China's population is equivalent in size to the combined populations of North and South America, Western Europe, Norway, Sweden, Australia and New Zealand. It is also a highly diverse country due to substantial regional differences. For example, a person from Shanghai may find it impossible to understand the local dialect in Sichuan, not to mention the province's spicy cuisine. This diversity affects companies entering China because selecting a region for entry can have a significant impact on future commercial success. China is not a single monolithic market.
- ii. **Uneven development:** Since market principles were first introduced by economic reforms in 1978, the Chinese government has focused on developing the coastal regions; in particular, three key economic development areas that are now typically more developed than those inland:
 - Bohai Bay area in the north, which embraces Beijing, Tianjin and surrounding areas
 - Yangtze River Delta, which embraces Shanghai, Zhejiang Province and Jiangsu Province
 - Pearl River Delta, which embraces Guangdong Province and surrounding areas, including Hong Kong.

To illustrate the disparity in development, consider that the GDP of Shanghai, a provincial-level city, is equivalent to the country of Finland, while the inland province of Guizhou boasts a GDP that is equivalent to Libya.

There are also significant differences in the development of cities. There is no official classification of cities into tiers, but it can be useful to consider cities with similar economic development when evaluating the opportunities and challenges in China's incredibly diverse landscape. 'Tier 1' cities include Shanghai, Beijing, Shenzhen and Guangzhou, while there are about two-dozen 'Tier 2' cities – Tianjin, Nanjing, Hangzhou and most of the provincial capitals. Tier 2 cities are relatively well developed and have received increased attention from foreign investors in recent years because operating costs can be significantly lower than in

Tier 1 cities. Further, there are many 'Tier 3' and 'Tier 4' cities that have also seen significant development.

In addition to giving a useful measure of population size, GDP and levels of infrastructure development, the Tier-level of a city also provides a quick and dirty way to assess its potential familiarity with, and receptiveness to, foreign businesses and brands.

In 'Business-to-Consumer' (B2C) sectors, the Tier 1 cities are saturated with foreign brands and local brands competing for business. Many brands are now therefore starting to focus on the Tier 2 cities because their wealth levels are beginning to approach those of Tier 1 cities.

In 'Business-to-Business' (B2B) sectors, headquarters will often be based in a Tier 1 city while the key business activities may take place in a lower-tier city or a development zone. China has intentionally clustered industries within specific development zones and there are likely to be several such zones nationwide that can cater to a particular sector.

- iii. **Undeveloped or nascent industries:** Many industries remain highly fragmented, sometimes with thousands of competing manufacturers, or their supply chains are unsophisticated and highly inefficient. Where industries are under-developed, regulations tend to be inconsistent or non-existent. This can pose a significant challenge for foreign investors.
- iv. **Constant and rapid change:** What was true about an industry last year may not be true this year. Both the competitive and regulatory environments are subject to rapid and considerable change, so it is essential for foreign businesses to be flexible and highly adaptable in China.

Market and industry conditions will vary greatly between different business sectors so it is essential that, in addition to these generalities, foreign investors should also fully understand the specifics in respect of their sector.

WHAT INDUSTRY SPECIFIC INFORMATION DO I NEED TO KNOW?

Before entering China, foreign investors should honestly assess how well they understand the opportunities by considering what they know about the following areas within their potential market in China:

- The market size, growth potential and possible opportunities for products or services
- The potential barriers or challenges to business entry, including market competition, protection of intellectual property (IP) or regulatory constraints
- The ability to identify target customers, pricing of products and services, key sales and distribution channels, and effective marketing activities
- Market segmentation and regional differences in China
- The most appropriate legal entity (if any) for your business needs
- The best location for your business and business activities in China.

Although it is possible to dive right into the market, this approach can waste time and resources and has led many foreign investors, both large and small, into untimely exits. Undertaking methodical market research before you enter China can provide an objective understanding about your market opportunities that could take years to discover by trial and error.

See *"Clean-Tech China"* on page 19.

HOW DOES CHINA'S BUSINESS ENVIRONMENT COMPARE TO OTHER COUNTRIES?

China is an emerging market that has experienced unprecedented growth. It may appear to be a modern and sophisticated country in the Tier 1 cities – Shanghai, Beijing, Guangzhou and Shenzhen – but the challenges facing foreign companies will often be similar to those experienced in other emerging markets, including:

- A lack of independent institutions i.e non-governmental organisations (NGOs), consumer protection or judicial bodies can lead to an absence of transparency in both state and local government operations.
- Vague and inconsistently enforced regulations: Clear legislation that is enforced equitably encourages adherence to written, verbal and implied agreements. In China, foreign-invested enterprises (FIEs) are in many cases held to a higher standard than their locally-invested counterparts, which often have local connections to officials that may have a vested interest in their success.

- The paramount concern of government – ultimately the Chinese Communist Party (CCP) – is to maintain stability and the legitimacy of its power. It is important to understand this fact because it may help to explain otherwise confusing policies.

HOW MIGHT THIS AFFECT MY ABILITY TO OPERATE IN CHINA'S MARKETS?

You will need to be actively involved in monitoring your relationships with both your suppliers and customers, enforcing and protecting your IP, and being explicit about the conduct expected of any local employees. Contracts are therefore critical because they:

- Provide you with a framework to discuss your relationship with a distributor or supplier
- Act as a last resort in the event that a dispute should arise.

You cannot assume that employees, business partners or government officials will share the same values as you, or value your presence and investment as much as you think they should. The active involvement of senior managers in your China operations can dramatically increase your chances for success.

You should not expect simply to set up a China operation, hire local employees, set targets and wait for the returns. China can be a lucrative market, but only for those who are willing to commit the necessary time and resources to understand it and contend with the complexities of running a business here.

See *"Multi-national Malaise"* on page 25.

ARE CONTRACTS IN CHINA ENFORCEABLE?

The ability to enforce contracts is improving as China's commercial sector matures, particularly in those regions and cities that are popular destinations for foreign investors. That is not to say that enforcement is likely to be as straightforward as you could expect in your home country. In other words, while there is a possibility of having an agreement enforced in China under a contract, there is almost no possibility of having an agreement enforced without one.

IS IT POSSIBLE TO PROTECT INTELLECTUAL PROPERTY (IP) IN CHINA?

IP protection is a serious concern for most companies in China – foreign or domestic. The key is to pursue a combined strategy of seeking legal protection through trademarks and patents, whilst also engaging in proactive, rather than reactive, enforcement. This entails educating employees, maintaining internal controls over access to your IP and identifying the means to limit its external availability. Of course, continuous innovation is often the best way to maintain an advantage over potential competitors and to avoid IP infringements impacting your business.

IF THE CHINESE MARKET IS SO RISKY AND COMPLEX, DO I BELONG THERE?

It is, and you might not. Analysing the strategic importance of China to your business and then assessing whether you have the resources to execute your plan is generally the best way to determine if a presence in China makes sense. Remember, a 'China plan' is not limited to setting up a company. You could begin by working with distributors to find out if sufficient demand exists for your products before committing to a real presence, or you could hire a sourcing firm to assist with finding suitable and reliable contract manufacturers to produce products to sell in your home country.

IS IT POSSIBLE TO OPERATE FROM HONG KONG INSTEAD?

Given its proximity to Mainland China, the Hong Kong Special Administrative Region could be a viable initial option either for selling into or sourcing from China. However Hong Kong is a distinct commercial jurisdiction with different legislation, legal system and currency from Mainland China. You will not be able to hire local Mainland Chinese to work for you legally on the Mainland, issue official invoices ('fapiao') that are recognised by the Mainland tax authorities to your Mainland Chinese clients, or spend a substantial amount of time on the Mainland developing and conducting business. As your business grows, you will have to consider a presence on the Mainland. Hong Kong may, however, be a good location to set up an offshore holding company for a Mainland China company.

WHAT WOULD BE THE BEST CORPORATE VEHICLE IF I DECIDE I NEED A REAL PRESENCE IN CHINA?

The most popular entity for doing business in China is the Wholly Foreign Owned Enterprise (WFOE), which is a company established in China according to Chinese laws and wholly owned by one or more foreign investors. A WFOE is a Limited Liability Company (LLC) that can:

- Conduct business activities and generate revenue based upon a limited business scope
- Hire local employees directly and, in many cases, has no limit for the number of foreign employees.

A WFOE's registered capital must be declared during the licensing phase of the company set-up process. This should cover initial investment expenses and may be used immediately for the company's operations. From commencement of the registration process, you should anticipate four to six months before a company is fully operational, depending on location.

A Representative Office (RO) can represent the interests of a foreign investor by acting as a liaison office for the parent company but has decreased in popularity due to its many restrictions. ROs are permitted to conduct market research and to develop partnerships and business channels, but all business transactions, including the issuance of invoices, must be managed by the parent company. An RO is taxed on its expenses and cannot generate revenues.

- The parent company must have existed for at least two years in order to be eligible to set up an RO in China
- ROs may not hire local employees directly and must rely on a government-authorised employment agency
- An RO is limited to four foreign employees
- There is no investment requirement because ROs are not classed as a legal entity in China
- The registration process takes around four months to complete, depending on location.

WOULD AN RO BE A BETTER CHOICE IF IT'S FASTER TO SET UP AND PROVIDES A PRESENCE IN CHINA?

An RO may be suitable for businesses looking to establish a short-term presence in China with no need to generate revenue, or for very limited sourcing ventures. However an RO should not be regarded simply as a way for new entrants to China to minimise their exposure in the event of failure because, in most cases, ROs do not provide the optimum platform for success and have the following disadvantages:

- **Liability:** An RO is not an independent entity. It is an extension of its parent company. As such, the parent company and the RO's Chief Representative take responsibility and liability for its operations. A WFOE provides greater protection because it is a form of Limited Liability Company (LLC). However it does not offer the same level of protection as in other jurisdictions, so an offshore holding company is often inserted between the Chinese entity and its ultimate beneficiary.
- **Capitalisation:** An RO has no registered capital requirement and instead generally pays taxes on its expenses (effective tax rate approximately 11%) because its purpose is not altruistic and it contributes indirectly to the revenue potential of its parent. If the Chinese tax authorities decide that an RO is generating revenues from outside its intended activities, they can levy a tax on its deemed revenues and income. A WFOE, on the other hand, is required to make an initial capitalisation, which is tax free, but is expected to pay taxes on both its revenues and profit. If a Chinese entity's expenditures exceed a certain threshold, a WFOE is, in fact, more tax efficient than the RO.
- **Scope of activities:** ROs are limited to providing business development, market research and support activities (such as quality control for sourcing from China), while a WFOE is permitted to generate revenues from the commercial activities prescribed in its business licence. If a business operating through an RO decides to begin selling products or services in the future, it will be required to re-establish as a new company. With a WFOE, however, it is generally possible to expand the scope of business to accommodate this.
- **Human resources:** An RO is not permitted to hire Chinese citizens directly but must use a licensed 'labour dispatch' service provider. However, many of these providers are refusing to dispatch local employees to new ROs due to recent changes in the labour laws. Furthermore, an RO is limited to no more than four foreign employees as Representatives, which includes the Chief Representative. A WFOE, however, can hire as many PRC citizens as it wishes, while its ability to employ foreign nationals is generally based on the size of its registered capital. Some local employees dislike being hired via a dispatch service provider and prefer direct-hire relationships.
- **Ongoing costs:** Generally speaking, the RO has fewer ongoing compliance costs than a WFOE, particularly in respect of accounting and tax compliance. However, depending upon the length of operations and the size of annual expenditure, a WFOE may be significantly less expensive to operate as a whole due to the lower effective tax rates and a five-year carry forward of losses.
- **Marketability:** A WFOE is perceived as a more substantial market presence and suggests to prospective clients or partners that a business has made a long-term commitment to the Chinese market. New market entrants often overlook this, but such a perception can be a significant barrier to business development.
- **Office location:** ROs are limited to leasing office space in locations that are specifically licensed to host ROs. Typically this means paying Grade-A office rents. A WFOE, however, can lease any office space that is zoned for its intended business. Neither an RO or a WFOE should use a 'virtual office' – this is unlawful and will create problems at both the registration and operational phases.
- **Flexibility:** It is generally possible to set up branch offices of a WFOE in other cities and expand the scope of a business to include additional lines of business, but this is not possible with an RO. ROs also cannot be converted into a WFOE. If you want to restructure, you will have to set up a new WFOE and consider if you need to close the RO.
- **Parent company:** The parent company of an RO must be at least two-years-old before it is permitted to establish in China. The Chinese government is discouraging the use of ROs and different locations may place additional restrictions upon the parent company before an RO is permitted to establish.

WHAT IS THE MINIMUM INVESTMENT REQUIRED TO SET UP A WFOE?

In 2014, China amended its Company Law to abolish minimum capital requirements. However, nearly every city with significant foreign investment can impose its own capital requirements for setting up a company. Furthermore, if your business is subject to additional licensing requirements, then a minimum capital investment may be imposed.

For most companies, the amount of minimum capital will depend on the location and the nature of the business. In other words, the officials reviewing your application will determine whether the amount you intend to invest is sufficient for your business activity. Authorities in the Tier 1 cities – Beijing, Shanghai and Guangzhou – generally regard CN¥1 million (approx. \$160,000) as a baseline and work on

the basis that the capital investment should be sufficient to cover two years of expenses. Ultimately the investor should invest sufficient capital to cover operating expenses until such time as it is anticipated that the WFOE will be cash flow positive.

It should be borne in mind that a company's registered capital can affect more than its registration. It is also relevant in the following circumstances:

- **Local employees' residence permits:** With a low registered capital, companies may not be able to sponsor temporary residence permits for local employees who reside outside the administrative district where the company is located. This could forcibly limit a company's talent pool.
- **Foreign employees:** Certain administrative districts in China will limit the number of foreign employees that a company can employ based on that company's registered capital.
- **Future adjustments:** The ability to make changes to a company's structure or set up branch offices could be hindered by a low registered capital.
- **Tax bureau relationship:** General VAT taxpayer status and export VAT rebate applications may be held up by the local tax bureau.

It may be that none of these four issues currently applies in the administrative district where a company is looking to establish. However conditions can change suddenly at the local level and this could have an impact on a company's future operations.

IS IT NECESSARY TO INVEST THE TOTAL AMOUNT AT ONE TIME AND, ONCE INVESTED, CAN THE FUNDS BE ACCESSED?

The sum invested covers both operating and capital expenses. China's Company Law has been revised to abolish the mandatory schedule for capital contributions. Restrictions may apply at the local level or special licences may impose an investment schedule, so it is helpful to be aware of the previously mandated schedule: for registered capital below \$2.1 million dollars, all funds were required to be paid up within six months of issuance of a business licence, or, if paid in instalments, 20% should be paid up within 90 days and the remainder paid over a maximum of two years from the issuance of the business licence.

SHOULD I INVEST ONLY THE MINIMUM CAPITAL REQUIRED BY THE LOCAL AUTHORITIES?

No. You should invest sufficient funds to sustain the company until such time as you expect it to be cash flow positive. Too many investors spend too much time finding ways to minimise their capital investments, only to find out that business expenses are greater than anticipated. Operating in China is not cheap; office rent and remuneration of experienced hires can rival that of developed nations.

It is also important to keep in mind that if funds are transferred to the WFOE in excess of the registered capital amount, it is treated as income and therefore subject to tax.

DO I NEED A PHYSICAL OFFICE ADDRESS TO SET UP A COMPANY?

Yes, in most cities you are required to have signed at least a one-year lease agreement. You must identify a location with a unique address that is correctly zoned for your intended business. Virtual office addresses are illegal and should be avoided in most cases. Some new ventures use virtual offices for their company set-up because disreputable agents mislead them. Potential problems often don't emerge until later but there are a number of situations where site visits are probable.

- **Initial registration inspections:** Companies that trade in certain goods will require additional permits to operate. It is not uncommon for these permits to require a visit to your office by a government official.
- **Approvals from State Administration of Taxation (SAT):** Whether it's an application for VAT-payer status or to begin processing export VAT rebates, visits may be required from the local SAT bureau.
- **Spot checks:** It is not uncommon for local authorities to visit offices to check the licences and certificates. If your company's licences do not match your physical set up, this could create problems and potential penalties.

As with the registered capital, it may be that the authorities in a particular district currently have a relaxed stance; but attitudes can change quickly and often in line with the prevailing outlook towards foreign-invested companies. You should consider that while locally-invested companies may flagrantly breach the law, foreign-invested companies are scrutinised more carefully. Chinese officials often favour high-profile campaigns to discourage illegal practices instead of blanket enforcement. Foreign-invested companies are almost always the first to be targeted.

See "The Graft Spiral" on page 33.

IS SHANGHAI'S PILOT FREE TRADE ZONE A GOOD LOCATION TO SET UP A COMPANY?

The China (Shanghai) Pilot Free Trade Zone (SFTZ) was formally launched in September 2013 in Shanghai's Pudong district. Initially the SFTZ comprised four existing bonded areas in Shanghai but this is to be dramatically expanded to include Shanghai's financial district and neighbouring development zones. The SFTZ, like many Chinese government initiatives at launch, remained ill-defined until the authorities gradually fleshed out the details of how it would be administered. The intended goal of the SFTZ is two-fold:

- To experiment with economic reforms that may eventually be rolled out nationwide (similar to the original Special Economic Zone in Shenzhen in 1980)
- To advance the prospect of its participation in global and regional trade and investment agreements.

An important feature of the zone is found in its 'negative list' approach to foreign investment, which is permitted in all sectors unless explicitly prohibited by the inclusion of a given sector on the Negative List published by the Shanghai Municipal Government. The SFTZ remains an important location for export-related businesses and could potentially be valuable for businesses in sectors that have been removed from the 'negative list'. It is important to bear in mind that many of the policies initiated in the zone have already been rolled out to the rest of the country. This trend is likely to continue.

WHERE SHOULD I SET UP MY OFFICE?

This is a complicated question but the main factors are likely to be the proximity to your customers and suppliers, as well as to available talent. If you are producing equipment for mining, for instance, then setting up in northeast China probably makes more sense than southern China. If you intend to establish in an area with little or no foreign investment, the challenges of operating in China will increase.

SHOULD I CONSIDER TAX INCENTIVES OFFERED BY DIFFERENT DISTRICTS?

State-sanctioned tax incentives were introduced in 2008 and focused on attracting specific kinds of foreign investment i.e high tech, environmental, certain professional services and others. Many local governments also provide tax incentives but these are not necessarily sanctioned by the state. In other words, business decisions should not solely be based on local tax incentives because these can be easily withdrawn.

SHOULD I CONSIDER AN OFFSHORE HOLDING COMPANY IN HONG KONG OR SINGAPORE?

Hong Kong or Singapore can provide a good base from which to access China, as well as other Asian markets. A holding company can act as a buffer between the ultimate beneficiary and the China entity, which could be beneficial for taxation and profit repatriation purposes. However there is a risk that the business could be deemed to be liable for taxes in China as follows:

- **Effective Management Rule:** If SAT deems an offshore company's day-to-day management to be located in Mainland China, the offshore company may be subject to corporate income tax in Mainland China. Offshore company residence can only be achieved if the offshore directors, wherever they are located, are permitted to exercise effective management of the company.
- **Reduced tax rate exclusions:** Offshore holding companies with no substantive business activities may be excluded from reduced withholding tax rates under tax treaties with Mainland China.
- **Indirect transfer of assets:** An investor that has structured an equity interest in a Mainland China enterprise through an offshore holding company could, in the event that the investor sells interests in the offshore company, be subject to an additional tax burden within China.

WHAT SHOULD I CONSIDER WHEN WORKING WITH SERVICE PROVIDERS IN CHINA?

- **Local government kickbacks:** China isn't cheap. It may appear to be so at first because it is not uncommon for local service providers to undercharge for their services and make it up with government kickbacks. Local tax bureaus will often provide subsidies to accounting firms based on how much their clients pay in taxes, while development zones offer agents percentages of the committed investment. Not all commissions are dubious but you should ask your service provider if they are receiving one.
- **One-stop-shops:** No one company has licences for every service, accounting, recruitment, real estate, HR or to practice law. It's OK to work with one company for everything, but make sure it is very clear who is doing what.
- **The China Expert:** There is no such thing as a 'China expert'. Run, do not walk, from anyone who tells you that they are one! This also applies to anyone who talks more about their great relationships ('guanxi') rather than demonstrating meaningful knowledge of the subject at hand.

WHAT SHOULD ALL FOREIGN INVESTORS CONSIDERING CHINA KEEP IN MIND?

“Trust, but always verify” should be the mantra for operating in China. From the expat who has lived in China for 10 years to the landlord of the new office you intend to rent, you must have systems in place to verify what you are being told. Not everything in China is fake but at some point nearly everything has been faked, even the eggs.



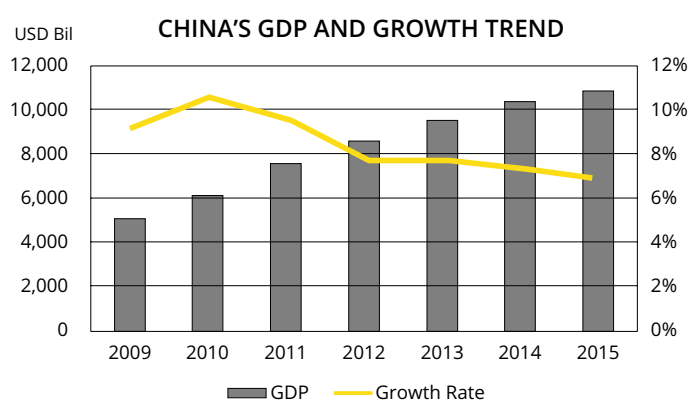
2. CHINA OVERVIEW

2.1 MARKET OVERVIEW

Since China began to open its markets to foreign investment in 1979, under Deng Xiaoping's 'Opening Up and Reform Policy', it has been a country of significant opportunity for both domestic and foreign enterprises. China is currently the world's second largest economy, only trailing the United States, with a Gross Domestic Product (GDP) of \$11.2 trillion as of 2016 at the official exchange rate. Furthermore, China's economy has been growing at an average of 10% annually since 2004, although economic growth has slowed to just under 7%.

Over the past five years, foreign direct investment (FDI) into China has grown at a compound annual growth rate (CAGR) of 6% to reach around \$118 billion in 2016, making it one of the largest recipients of FDI worldwide.

The charts below illustrate China's GDP and GDP growth:



Year	GDP (\$ Billions)	Growth Rate (%)
2016	11,200	6.7
2015	11,063	6.9
2014	10,483	7.3
2013	9,611	7.7
2012	8,560	7.8
2011	7,576	9.5
2010	6,101	10.6
2009	5,110	9.2

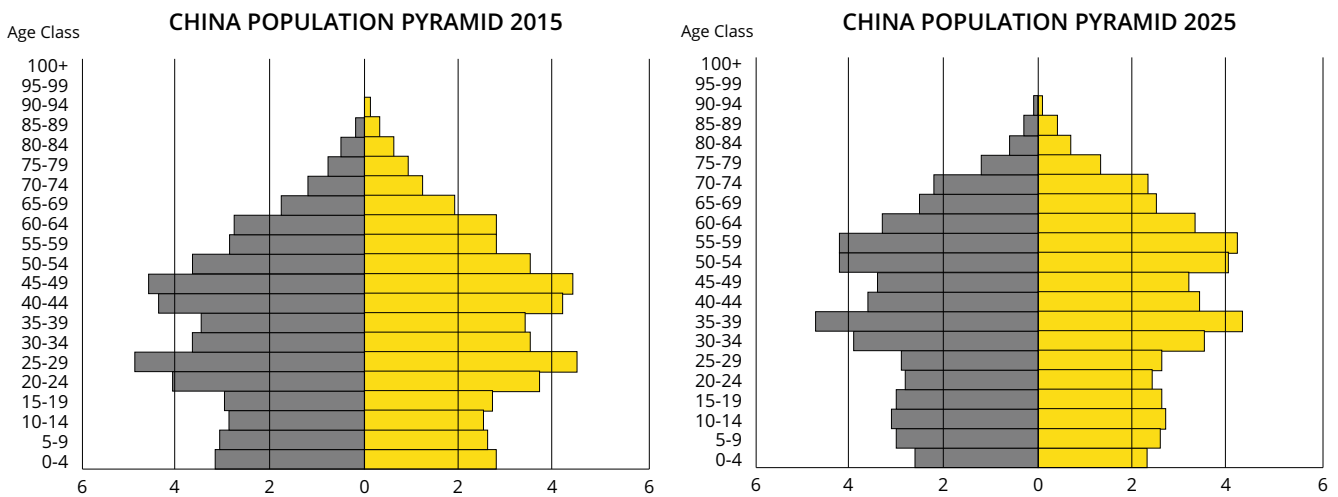
Source: China Ministry of Commerce (MOFCOM) and Statistics Bureau www.fdi.gov.cn



i. DEMOGRAPHICS

With nearly 1.4 billion people, representing 20% of the world's population, China is the world's most populous country. From 1950 to 1980, the population grew by a staggering 78%, which led the government to introduce the 'One-Child Policy' in 1979 in a bid to slow population growth. This policy has resulted in a steady decrease in the population growth rate over the last three decades and the population growth in 2011 was only 4.8%. Although the policy achieved its goal, it has created other socio-economic challenges, not least a shrinking future workforce that will need to support a larger ageing population. In 2010, the ageing population (people above 60-years-old) accounted for 12.5% of the total population. This rate is estimated to exceed 23% by 2030. Understanding the challenges, the central government revised the 'One-Child Policy' in 2015, allowing couples to have two children.

The chart below illustrates the stark shift in the demographic from 2015 compared with the projections for 2025.

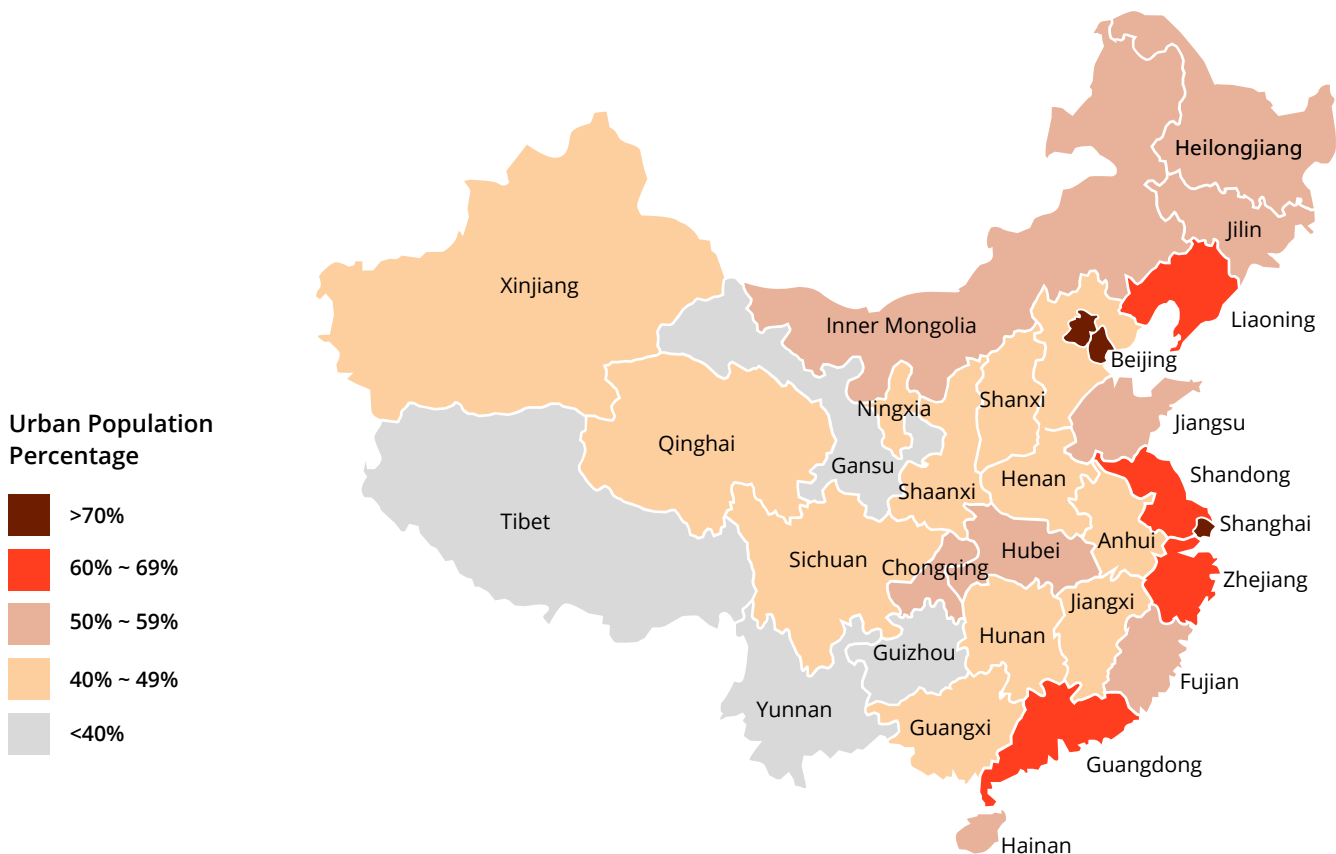


Source: Sovereign analysis of data from the United Nations, Department of Economic and Social Affairs, Population Division



ii. URBANISATION

Urbanisation is generally linked to the modernisation of an economy, as people migrate from rural areas to live in cities, mainly in search of new job opportunities. This is a developing phenomenon in China, which has a current estimated urban population of 740 million, accounting for 54% of the total population. The rate of urbanisation is expected to increase 1% per year for the next two decades, which is equivalent to urbanising 300 million people in 20 years. The map below illustrates the urban population percentage by province/municipality.



Source: Sovereign analysis of data from the PRC National Bureau of Statistics

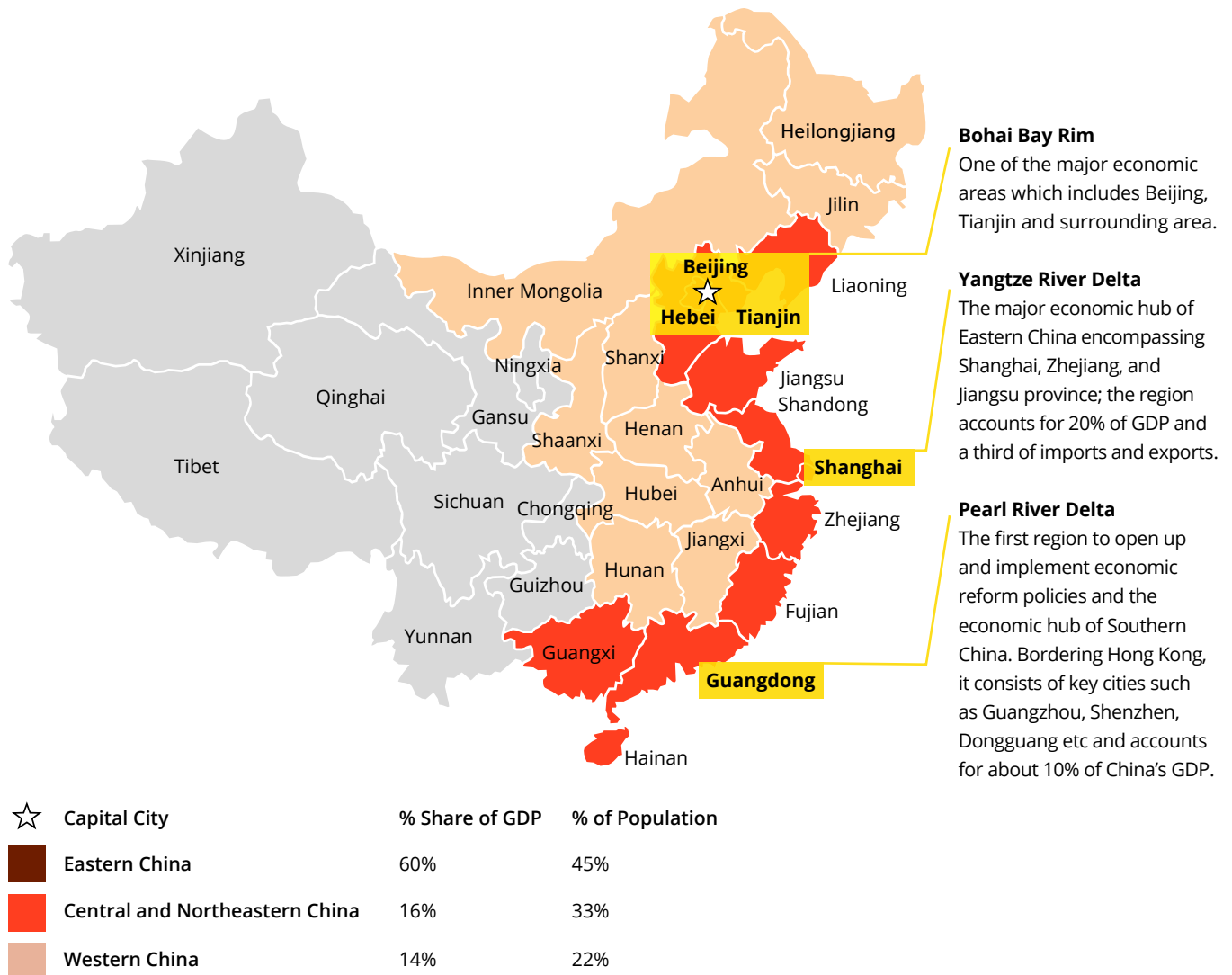
iii. CHINA'S EXPANDING MIDDLE-CLASS

As China has grown economically, so too has the wealth of Chinese households. Millions have been lifted out of poverty over the last 30 years. China's middle class, who can generally be defined as those with an annual salary between \$10,000 and \$17,000, now accounts for more than 476 million people, which is larger than the entire population of the United States. The upper-middle class, which has an annual income of up to \$38,000, accounts for 14% of urban households and is expected to increase to 54% by 2022. It is the middle class, especially the upper-middle class, that will drive domestic consumption of goods and services in China.

2.2 REGIONS OF CHINA

i. CHINA'S REGIONAL DIVIDES

China is divided into 34 provincial-level administrative units, with four direct municipalities, Beijing, Chongqing, Shanghai and Tianjin. China also has two Special Administrative Regions (SAR), Hong Kong and Macau, that are semi-autonomous and self-governing. There are three key economic regions, the Bohai Bay, the Yangtze River Delta and the Pearl River Delta, that attract a majority of foreign direct investment and are key economic hubs.



Source: Sovereign analysis of data from the PRC National Bureau of Statistics

It is often assumed that China is well integrated but in reality the market is highly fragmented. In fact it is a bit like Europe, with each province having its own culture, tastes and dialect. Fiscal decentralisation during the 1980s increased local government responsibility for economic management and therefore also increased local protectionism and competition amongst provinces.

Eastern China is by far the most prosperous and populated area and includes the Bohai Bay, Yangtze River Delta and Pearl River Delta. The region has many manufacturing centres and boasts some of the world's largest seaports. Growth in Eastern China has slowed in recent years, with increasing costs leading some businesses to relocate to Central China, but the area is still the main recipient of foreign direct investment and typically is the beachhead for an enterprise entering the China market.

Central and Northeast China are progressing steadily, with the central government allocating a larger portion of their budget to infrastructure spending. The high-speed railway network has improved inland logistics to the extent that a journey from Wuhan to Guangzhou, which used to take 11 hours, now takes only three. Traditional labour exporting provinces such as Anhui and Jiangxi are also now benefiting from this development with workers staying closer to home.

Development in the Western provinces of China has lagged considerably. In order to bolster economic development of the region, the central government implemented its 'Go West' policy in 2000 to encourage foreign investment, improve infrastructure and retain talent. Although significant investment has been injected into the region, including a recent package promising to invest \$108 billion on infrastructure development, the effects have been limited and the economic gap between Eastern and Western China continues to grow.

ii. CITIES IN CHINA

Cities in China are characterised by an unofficial 'tier' system. A city's tier is typically reflective of its population, economic size, history and other factors such as levels of economic development and infrastructure. Although there is no formal definition of what constitutes a Tier 1, Tier 2 or Tier "X" city, it is generally acknowledged that the Tier 1 cities in China consist of Beijing, Shanghai, Guangzhou and Shenzhen. They are all highly populated, with income levels typically above the national average CNY53,000 (\$8,400), and have highly developed infrastructures and more developed markets.

While Tier 1 cities have received a significant amount of attention from foreign businesses and media, major opportunities also exist in Tier 2 cities (Hangzhou, Tianjin and Suzhou, as well as most provincial capitals) and Tier 3 cities (Jiangmen, Changshu, Dandong, Wuxi, etc.). Many of the opportunities are driven by the increasing purchasing power and rising middle class of the lower tier cities; it is expected that over 80% of China's middle class will be living in the lower tier cities (Tiers 2, 3 and 4) by 2022. The central government is also investing heavily, and has increased spending on housing projects and infrastructure as part of its initiative to develop the lower tier cities.

2.3 CHINA'S 13TH FIVE-YEAR PLAN

Beginning in 1953, 'Five-Year Plans' have been implemented by the central government as a way to promote and guide economic and social development. We are currently in the 13th Five-Year Plan period (2016–2020). Although the Five-Year Plans are typically general in nature, they provide a good indication of the potential opportunities for certain industries.

The 13th Five-Year Plan focuses on stable growth through reforms to key economic sectors, as well as social reforms. In some ways, it is an extension of many of the reforms that began in 2015, such as reforms to the country's one-child policy and restructuring inefficient sectors of the economy such as steel production. The Plan also reaffirms "the new normal" for economic growth. The Plan sets GDP growth targets at 6.5% in order to "build a moderately prosperous society" by 2020. Although this is still ambitious from a global perspective, it is a much lower target than in previous years.



Below is a description of several key chapters in the 100-plus page 13th Five-Year Plan, along with a summary of what they intend to accomplish. There are additional chapters within the Plan, and the entire document can be found at: http://www.gov.cn/xinwen/2016-03/17/content_5054992.htm

Highlights of the 13th Five-Year Plan (2016-2020)

Key Theme/ Topic	Sections	Chapters	Page Length	Summary
Innovation: Science and Technology	2-5	6-28	38	This is effectively a shift from heavy industry to more information-intensive areas. The R&D sector is targeted to account for 2.5% of GDP by 2020.
Coordination: Regional development and integration	6-9	29-41	28	Focus on developing small and medium sized cities, increase rural per capita income, improve rural infrastructure and public services, and reform the "hukou" system.
Green: Environment and resources	10	42-48	15	The goal is to develop environmental technology industries further as the government intends to cut CO2 emissions by 18%, as well as reducing other pollutants.
Openness: International trade and investment	11-12	49-53	7	An increase in international co-operation and leadership, which has already begun to take shape in the form of the Asia Infrastructure Investment Bank, which started operation on 25 December 2015, and the "Belt and Road Initiative". China is also expected to further accelerate the liberalisation of the financial sector and including capital markets, banking and insurance, and the social services sector, such as aged-care, healthcare and education.
Shared Growth: Social welfare	13-16	56-59	29	Aimed at closing the massive welfare gap between rural and urban households. Investment is expected to improve rural infrastructure, including roads and access to water, power and the Internet.
Governance: Social and political institutions	17-18	70-76	10	Develop or expand sectoral governance systems, including rule of law, increase credibility of the judicial systems, and improve human and property rights.

Source: Sovereign Analysis

Although the Five-Year Plan does not identify specific opportunities for foreign companies, it does provide a guide to the key sectors that stand to benefit. For example, we expect to see opportunities in healthcare, aged-care, child products and other industries targeted in the Plan.

2.2 OPPORTUNITIES AND CHALLENGES

i. SELECTED OPPORTUNITIES

Commercial opportunities exist across several sectors of the China market, including the three examples below:

- **Children, baby and maternity products:** Between 15 and 20 million babies are born in China each year. The year 2015 is estimated to be the start of a new round of baby boomers and this is likely to continue to 2022. Most of these parents were born in the 1980s and are better educated. With the likelihood of a more relaxed one-child policy to counter the negative growth in the labour population, the growth rate of newborn babies is likely to increase. The number of babies aged between zero and four-years-old exceeded 82 million in 2015. Furthermore, total retail sales of child, baby and maternity products increased by a Compound Annual Growth Rate of 15% from \$26 billion in 2007 to \$81 billion in 2015; this growth is expected to continue into the near future. Considering the increase in the purchasing power of China's middle class and their concerns for the health and development of their offspring, these parents are willing to spend a large proportion (\$800 to \$2,900) of their annual household income on child, baby and maternity products. This provides significant market opportunities for producers and investors in China.
- **Elderly healthcare and home medical:** China's aging population has put an increasing strain on the retirement system, resulting in a shift from six workers supporting one retiree in 1975 to a predicted one worker per retiree by 2035. To satisfy the needs of an elderly population, the government has introduced various measures, which include permitting foreign investment in hospitals and basic medical insurance. In October 2014, the National Development and Reform Commission (NDRC) issued a notice stipulating that social capital is encouraged to co-operate with local governments through PPP (Public-Private Partnerships) and investing in medical, elderly healthcare, sports and fitness facilities; including through WFOEs, JVs, partnerships, equity investments and leasing. This policy has further lowered the entry barriers for social capital to invest in this sector.
- **E-commerce retail:** China's traditional retail channels are still predominantly regional and highly fragmented. It is extremely difficult for retail companies to scale up and develop national coverage in such a large and diverse developing country, creating the perfect environment for e-commerce to thrive. With online retail sales growing from \$20 billion in 2008 to nearly \$650 billion in 2015, China has become one of the world's largest e-commerce markets. Online retail will continue to grow and sales are expected to reach \$1 trillion by 2019. For more information on China's e-commerce market, please visit Sovereign's website at www.sovereigngroup.com/china/china-additional-services/china-industry-reports/ to download our China e-commerce guide.

ii. BUSINESS CHALLENGES

Entering and growing in the China market can be a daunting and sometimes frustrating task for managers of foreign-invested enterprises. The way in which managements address these challenges, is critical to success in this highly dynamic and competitive environment. Although hurdles will vary according to the specific company, sector and location, there are four key issues that are common to nearly all enterprises doing business in China:

1. **Market knowledge:** Gaining market knowledge in developing countries, especially China, is significantly more challenging than in developed countries due to the size and diversity of the country, the lack of reliable centralised/official information databases, and the constant and extremely rapid changes. China is roughly the size of the United States in terms of geographical area. China is also a country where information is coveted and not freely accessible. As a result, there are generally no single reliable sources where information on an industry or company can be obtained. Market knowledge has to be obtained 'on the ground'. It is a mistake to assume that it can be obtained through several visits to the market or through a few insiders. Acquiring reliable market knowledge on which to base sound business decisions requires considerable investment in time and effort.
2. **Immature markets:** Most of China's markets (if not all) are immature, and foreign-invested companies will face challenges that they would not experience in mature markets, such as a lack of consolidation, limited brand recognition and a highly price sensitive customer/consumer base. The mentality of buying something that is 'good enough' is still prevalent among many consumers and businesses alike; the assumption is that it is cheaper to use and replace than to buy a quality product that has a higher life utility. Companies will need to consider the best way to approach and manage doing business in a developing marketplace.

3. **Regulatory environment:** There are situations when regulations may be difficult to understand or are inconsistently enforced. This is often due to loosely interpreted regulations or the involvement of multiple authorities in oversight. Companies must ensure that they fully understand the regulatory environment before entering the China market.
4. **Local company advantage:** In most markets, local companies tend to have an advantage relative to overseas entrants. This is especially true in China and in a number of different ways. Domestic companies will have a head start on foreign competition in understanding customers and market conditions, although this is not always the case. It is especially important for foreign companies to gain market knowledge and insights if they are to mitigate local company advantages and, in some cases, foreign entrants may need to work with local partners in some capacity.

Understanding opportunities and challenges within an industry, or those facing a specific firm, are necessary to make informed market entry or growth decisions. China's rapidly changing economic environment, inconsistencies of interpretation and enforcement of regulations, together with the general lack of transparency, make understanding opportunities and challenges all the more daunting. Engaging the services of a qualified consultant can provide up-to-date market knowledge, help identify and vet potential partners, and will substantially improve the chances of a successful market entry.

CASE: CLEAN-TECH CHINA

A mid-sized chemical company focused its attention on China as the next market into which to launch its clean-tech products. The company's traditional customers in North America are power plants and the company assumed that China would be the same.

The company chose to conduct research into the market to assess the needs of their potential customers and also review any potential regulatory barriers that might prevent it developing business. During this research, the company found that power plants in China were not an ideal target customer because most operate at a loss and are unwilling to invest in new equipment or services unless ordered to do so by the government. However, they did find an alternative customer base that made China an even more significant market than they had anticipated.

By investing resources upfront to understand the market, the client was able to save time and money by targeting the right customers for their go-to-market strategy.



3. ESTABLISHING A LEGAL ENTITY IN CHINA

3.1 PENDING CHANGES TO CHINA'S FOREIGN INVESTMENT LAW

2016 saw significant changes to the system for government control over foreign investment and therefore to the process of entering the China market. The change was accomplished by revising, as of 1 October 2016, the statutes concerning wholly foreign owned entities (WFOEs), equity joint ventures and contractual joint ventures and by promulgating a new basic regulation governing registration of foreign invested entities (FIEs).

The big change is that government regulation of FIEs has moved from a system that requires MOFCOM (China's Ministry of Commerce) approval to one that will now just require simple registration with MOFCOM. The Foreign Investment Catalogue, which set out the sectors of the economy in which foreign investment was encouraged, while restricting or prohibiting investment in many others, has been abolished. In its place, two 'National Negative Lists' have been introduced, one covering domestic and foreign investors, and another list with additional limits on foreign investment, which delineate sectors of the economy where certain Chinese agencies would continue to require investors to secure approval from those agencies for investment projects.

For FIEs that are not restricted or regulated under the National Negative Lists, MOFCOM requires online registration through a national website employing a standard set of documents. This registration will apply to initial formation of the FIE and to most changes in FIE structure, such as changes in management, ownership and registered capital. A new element in the registration process is the appointment of the actual controlling person.

Overall, some changes have been for the better, others have made setting up a company in China one step more difficult. In this chapter we set out what you need to know to set up an entity in China.

3.2 NATURE OF THE INVESTMENT

When a foreign investor chooses to enter the China market, they will first need to decide whether to launch their business by establishing a legal entity with a capital investment in China or to start more cautiously by testing the market, building networks and/or hiring local representatives.

If a legal entity is the preferred route, the foreign investor will have to consider, in addition to the general commercial and strategic considerations, the following:

- The business sector
- The amount to be invested
- Whether a Chinese partner is desirable or even mandatory.

Government rules for specific industries may affect the size and form of the investment. For instance, the media, automotive and telecom industries are all sectors that may require FIEs to have local partners. The new 'Negative List' provides guidance as to which sectors are open or restricted.

iii. REPRESENTATIVE OFFICE (RO)

A Representative Office (RO) can represent the interests of a foreign investor by acting as a liaison office for the parent company. ROs can conduct market research, develop partnerships and business channels and, since they do not have a minimum investment requirement, ROs are not considered to be a Foreign Invested Enterprise (FIE). ROs were the least complicated way for a foreign firm to have a legal presence in China and were, at one time, the first choice for foreign companies with little or no previous experience in the country.

However all business transactions, including the issuance of invoices, must be managed by the parent company and ROs can only hire a maximum of four foreign employees. Any local employees must be hired through government-authorised employment agencies. ROs are usually taxed on a proportion of gross monthly expenses. Given the restrictions on transactions, employment and the taxation on expenses, WFOEs are generally considered a better option for entrants seeking to develop their business in the China market.

iv. WHOLLY FOREIGN OWNED ENTERPRISE (WFOE)

A WFOE is a Limited Liability Company (LLC) that is fully invested by one or more foreign investors. Along with the rights afforded to an RO, a WFOE may also conduct business transactions within China and hire local employees on its own accord. However, foreign investors are required to make an investment into the company and, depending upon the business activity, there may be a minimum capital requirement. WFOEs have begun to outpace joint ventures as the most popular vehicle for a China presence.

v. JOINT VENTURE (JV)

There are two types of joint venture structure in the China market:

1. **Equity Joint Venture (EJV):** EJVs have capital investments from both local and foreign firms. The percentage of the capital investment determines the amount of profit and risk that both the foreign and local company assumes. Foreign firms entering business sectors where WFOEs are prohibited often use EJVs, although this is becoming less prevalent as more and more sectors are being opened up to WFOEs.
2. **Cooperative Joint Venture (CJV):** CJVs are also partnerships with a local company; however, the amount of risk and profit shared by each party is not determined by capital investment but is agreed upon at the beginning of the partnership. CJVs were used more frequently in the 1990s when the Chinese economy was not as developed. International companies often injected funds, while local Chinese companies provided equipment and other necessities. Laws, regulations and procedures for establishment can vary substantially between sectors. The common risks associated with entering into partnerships also apply in China but this is often exacerbated by disparities in the culture and business practices between the foreign and local partners.

Foreign companies should enter into JVs only when both parties have established a clear understanding of the business objectives and appropriate exit strategies have been developed.

Steps that a foreign company could take to assess the viability of the JV are:

- Undertake thorough due diligence on your proposed JV partner. If there are no legal, financial or reputational issues, you can proceed with a clear mind. If something does come up, you can choose your next step. Good due diligence will always give you leverage.
- Ensure that the JV agreement states that any disputes must be handled in China. Foreign companies often believe that litigation or arbitration is best done outside China, preferably in their home country. But in reality this will offer little protection to a foreign company. A foreign court or arbitrator has NO authority in respect of a China JV.
- Ensure that you retain the power to appoint the legal representative and the general manager, because this will give you effective control over the JV. Securing a majority of board seats or even a majority shareholding will not.
- Hire your own legal counsel when setting up the JV. Do not rely on the Chinese JV partner to undertake the legal work for establishment. Your interests in this process are not aligned. Find a foreign lawyer with experience in China.

- Hire an independent accountant, rather than using one that is recommended by your JV partner. This should ensure that you retain transparency on what is happening within the JV.
- Outsource the control and maintenance of sensitive documentation, such as company certificates, seals (known as 'chops' in China), permits or licences. This will ensure that no contracts can be signed without your knowledge or approval.

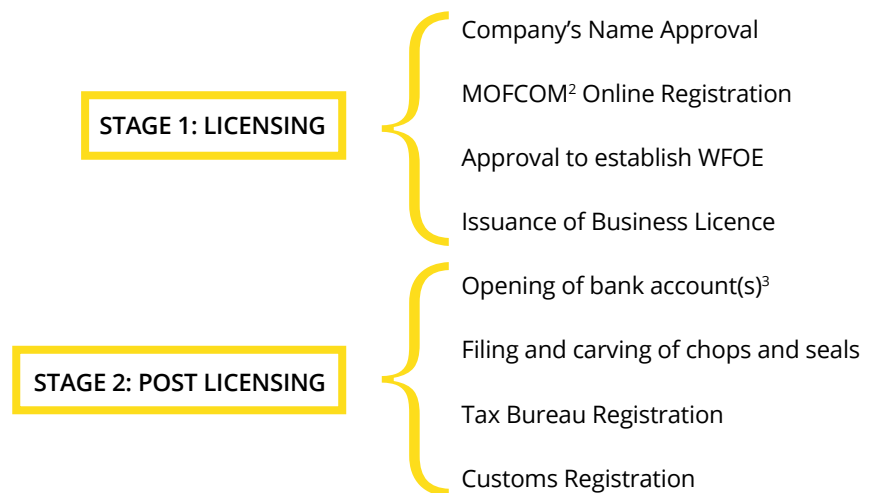
vi. MERGER AND ACQUISITION (M&A)

M&A has become an increasingly popular route to foreign investment in China in recent years. There are many options for M&A in China, including equity and asset acquisitions, as well as mergers. As a form of foreign direct investment, the general rules on establishment of FIEs also apply to any M&A.

3.3 REGISTRATION STEPS

In 2015, the Chinese authorities revised the company registration process to unify the business licence. To simplify the registration process, the new business licence combines the organisation code certificate, tax registration certificate and the business licence into one certificate. Set out below is the typical process for setting up both FIEs and ROs in China. The government offices involved in this process include the Commission of Commerce, the Administrative Bureau for Industry and Commerce, the Tax Bureau and the Customs Office.

General WFOE Company Registration Process¹



1) This is a general process for establishing a WFOE in China, some sectors may require additional steps

2) MOFCOM – Ministry of Commerce

3) Conducted by the client or during the accounting set-up in China

3.4 REGISTERED CAPITAL

Registered capital is the amount of capital required to support the operations of a WFOE until such time as it becomes cash flow positive. Effectively it is the company's working capital. It is important that the registered capital amount is sufficient because any funds injected by the parent company in excess of the registered capital amount will be treated as income to the WFOE and therefore subject to tax.

Prior to March 2014, all FIEs were required to register a minimum capital amount and to pay up their capital over a prescribed period of time. With the introduction of China's amended company laws, both minimum capital requirements and the prescribed investment schedule have been abolished.

Although the Chinese government has abolished minimum capital requirements, local bureaus may in practice still require foreign investors to commit to a minimum amount, based upon previous investment expectations, before approval is granted. In general, the investment required is dependent upon the business scope, volume of sales, company size and location. This is judged on a case-by-case basis. The Chinese authorities will assess what would be a reasonable capital injection for each specific project.

The amount of registered capital must be declared during the licensing phase of the registration process. The total investment figure is represented by the ratio between foreign-contributed capital and debt. The registered capital should cover all the FIE's initial investment expenses and may be used immediately for the newly-formed company's expenses. It is unlawful

to inject the funds as stated and then withdraw them. One purpose of the registered capital is to provide confirmation to creditors of a company's financial adequacy. A general rule of thumb is that the injected capital amount should be sufficient to cover the first two years of expenses.

3.5 ACTUAL CONTROLLING PERSON

The 2016 revisions to China's Foreign Investment Laws now require that the controlling person or persons of an FIE must be identified. The actual controlling person is defined as either those person or persons who:

- Collectively have 50% ownership in the foreign investor that will establish the FIE in China; or
- The persons who actually control the foreign investor through means other than ownership (e.g. control over the decision-making).

As a result, special purpose vehicles (SPVs) and other structures used to hide the identity of investors will no longer be viable options for investing in Chinese entities. The policy is primarily intended to prevent 'round-tripping' – where Chinese individuals invest in overseas companies that then reinvest in China – but will affect most companies investing in China and potentially create a significant amount of additional documentation requirements. Unless the investor in an FIE is a publicly-traded company, the individuals that have control must be identified. Since control of many private companies is purposefully decentralised, all individuals that collectively control the investing entity will need to be identified.

3.6 NATURE OF THE BUSINESS

For FIEs, both WFOEs and JVs, the activity of the business must be declared during the licensing phase of the registration process. This is known as the 'Business Scope'. The intended scope of operations that a foreign company declares will determine its business category in China.

The following categories represent the most common classifications for FIEs operating in China today:

- **Service Company:** An FIE providing services to either companies or consumers. In most cases, the company may not manufacture or trade goods. Examples of service activities include consulting, training, restaurants and management services.
- **Manufacturing Company:** An FIE producing goods for sale. Manufacturing companies do not require an intermediary to sell goods locally or internationally and may import raw materials for production. The registration process, however, may be more complicated than other business categories because manufacturing plants often require additional certifications.
- **Foreign-Invested Commercial Enterprise (FICE):** A FICE provides greater flexibility in terms of business activities. These activities include retail, wholesale and franchising operations. When established, a FICE is often granted both import and export rights, although additional certifications from various bureaus will be required to commence international trade. FICEs may also buy and sell products freely in China without an intermediary. It is possible for manufacturing FIEs to apply to extend their business scope to include FICE capabilities and vice versa.

Other categories of business include: Purchasing Centres, Research & Development Centres, Investment (Holding) Companies and Regional Headquarters.

As foreign companies entering the market begin to navigate the bureaucratic landscape, having a clear understanding of the investment and business options available will be crucial to operating successfully in China. As China's compliance with its World Trade Organisation (WTO) obligations develops, the business registration process should continue to improve and further business sectors should be opened up to foreign investment.

When choosing a business registration agency, foreign companies should consider the agency's knowledge of policies, its transparency in respect of the registration process and its track record of successful registrations. Another important consideration when selecting a business registration agency is the company's reputation. Selecting a service provider that can effectively guide foreign investors through this complicated process should ensure a smooth market entry.

A detailed summary of entity types and their respective permitted business scope, tax treatment and registration process can be viewed on the following Legal Entity Comparison Chart.

Chart: Comparison of Different Legal Entities in China

	Business Activities*						Registration Process						Notes
	Import	Export	Domestic Commercial Activities	Service Activities	Manufacturing/ Assembly Rights	Tax Treatment	Min. Registered Capital**	Duration of Entity †	Potential for Future Expansion of Scope ‡	Registration complexity	Approx. Time to Register#		
Representative Office	●	●	●	●	●	●	N/A	1 Year	●	●	1 Month	<ul style="list-style-type: none"> Cannot issue invoices Intended for market research and business development activities only Cannot directly hire local employees Taxed on expenses 	
Service	●	●	●	●	●	●	N/A	30 Years	●	●	2 Months	<ul style="list-style-type: none"> Products may only be sold coupled with services 	
Manufacturing	●	●	●	●	●	●	N/A	30 Years	●	●	3 Months	<ul style="list-style-type: none"> Distribute products manufactured in-house Additional time may be needed for special licences 	
FICE	●	●	●	●	●	●	N/A	30 Years	●	●	2Months	<ul style="list-style-type: none"> May be authorised for Retail and/or Wholesale Franchising and direct selling available through approval Commercial activities are limited to like products 	
FICE + Manufacturing	●	●	●	●	●	●	N/A	30 Years	●	●	3 Months	<ul style="list-style-type: none"> Tax incentives at risk if production is less than 50% of total revenues 	
Specialized Corporate Formations													
Investment Holding RHQ	●	●	●	●	●	●	\$30,000,000	50 Years	●	●	6 Months	<ul style="list-style-type: none"> Provides management & corporate services to investments Incentives can be negotiated with local government M&A activities are allowed May include R&D centre 	
Management RHQ	●	●	●	●	●	●	\$2,000,000	50 Years	●	●	3 Months	<ul style="list-style-type: none"> Limited management and corporate services for investments Incentives can be negotiated with local government (but not as optimal as Investment RHQ) 	
R&D Centre	●	●	●	●	●	●	\$2,000,000	50 Years	●	●	3 Months	<ul style="list-style-type: none"> Incentives may be negotiated with local government Must maintain a minimum of 80% of staff with advance degrees 	

Source: Sovereign Analysis

● = Ideal

● = Prohibited

* Denotes activities that may generate revenue streams for the entity

** This reflects the minimum as stated in China's Company Laws and does not guarantee approval.

† This reflects the maximum duration the entity may be approved by the government. All entities' licences may be renewed before expiration.

‡ Capability of the entity to expand to include additional capabilities (i.e., Manufacturing entity expands to include FICE capabilities; Distribution FICE expands to include franchising and retail).

Approximate Time refers to the time required to obtain the licence, commencing only upon the complete collection of all required documents.

CASE: MULTINATIONAL 'MALAISE'

A developer of automated manufacturing control systems establishes an office in Shanghai to attract talent and to be near its potential clients. It appoints a high-performing senior manager from North America to head up the office for a year in order to cultivate the team and oversee its integration into the international business. By the time the senior manager returns home, the sales team has generated a robust pipeline that outperforms initial expectations.

Soon after, the parent company acquires a value-added reseller in Singapore. Due to cultural affinity, the parent company decides to place the Shanghai office under the supervision of the newly-acquired Singapore operation instead of promoting an employee in the Shanghai office to lead its China initiative. Within six months, half the sales team in Shanghai has quit and most of the other employees are on their way out the door.

Market entry does not end with the company set-up and cultures are not limited to ethnic groups.



4. TAXATION OF FOREIGN INVESTED ENTERPRISES IN CHINA

Foreign companies that engage in business operations in China are required to pay taxes according to the local tax codes. The most important tax categories for these forms of businesses are the Corporate Income Tax (CIT) and Value Added Tax (VAT).

4.1 TAX REGISTRATION AND TAX ENTRY

When a business licence is issued, an RO or WFOE must register with the relevant tax authorities within 30 days. This includes both the national taxation bureau and its municipal branch; however, only one application needs to be submitted. Generally, the application process takes 10 working days. Companies are not required to hire an authorised agent for this process and can apply themselves. However, if the investor has used a registration service provider for the registration of the RO or WFOE, a tax application service will often be included.

4.2 MAIN TAX CATEGORIES FOR FOREIGN ENTERPRISES

- Corporate Income Tax (CIT)

CIT is levied on income of companies derived from production, business operations and other sources, both within and outside China.¹ Companies are required to pay this tax quarterly and the applicable tax rate is currently 25%. If a company is not registered in China, however, it only has limited tax liabilities for all revenues generated from within China. The applicable CIT rate for this kind of company is 10%. The method of computation for CIT is as follows:

$$\text{Tax Payable} = [\text{Total Annual Income} - \text{Expenses} - \text{Losses}] \times \text{Applicable Tax Rate}$$

- Value Added Tax (VAT)

Value Added Tax is a general tax that is charged at each stage of commercial activity involving the production and distribution of goods and the provision of services. The tax is applied only to the 'value added' at each particular stage of production and distribution of goods, or the provision of services.

China's tax system distinguishes between general and small-scale payers of VAT as illustrated in the chart below.

Classification of VAT Payers	VAT Rate	Note
General Tax Payer	Regular Rate: 6-17% Preferential Rate: 3-13% (non-services only)	General Tax Payer Status is typically given to enterprises with annual revenues exceeding CN¥5 million. An FIE's VAT classification can be changed by application.
Small Scale Tax Payer	Unified Rate: 3%	

Source: Sovereign Analysis

¹ If a company is not registered in China, it only has limited tax liabilities for all revenues generated from within China. The applicable CIT rate for this kind of company is 10%.

- General VAT Payers

The actual amount of VAT payable by general VAT payers is the excess amount of output VAT over input VAT. The tax rate can vary between 6% and 17% depending on whether it is applied to the production and distribution of goods or the provision of services. The type of goods and services will also affect the applicable tax rate.

The tax payable for general VAT payers is computed as follows:

$$\text{VAT Payable} = \text{Current Output VAT} - \text{Current Input VAT} - \text{input VAT credit from previous months}$$
$$\text{Output VAT} = \text{Sales Volume} \times \text{Applicable Tax Rate}$$

In addition to the VAT Payable, there is also a VAT Surcharge, which is applied at the local administrative level. The actual VAT surcharge will vary depending on the jurisdiction, but typically ranges from 0% to 12%.

$$\text{VAT surcharge payables} = \text{VAT Payable} \times 12\%$$

- Small-scale VAT Payers

The VAT payable by small-scale taxpayers is calculated more simply on the basis of the overall sales value and the tax rate without deduction of an input VAT. This means that input VAT paid by small-scale VAT payers on the purchase of goods from general taxpayers is not refunded by the tax authorities. The applicable tax rate is 3% for wholesale, retail, manufacturing enterprises and services.

The tax payable for small-scale VAT taxpayers is computed as follows:

$$\text{VAT payable} = \text{Sales Volume} \times 3\% / (1+3\%)$$

- VAT Surcharge

In addition to the VAT Payable, there is also a VAT Surcharge, which may be applied at the local administrative level. The actual VAT surcharge will vary depending on the jurisdiction, but typically ranges from 6% to 12%.

$$\text{VAT surcharge payables} = \text{VAT Payable} \times \text{Surcharge Rate}$$

- VAT on Manufacturing, Wholesale and Retail Sectors

VAT for the Manufacturing, Wholesale and Retail Sectors has been fairly consistent over the years. In 2012 several pilot programmes were launched throughout China to replace the Business Tax (BT) system with a VAT system for services. The purpose of this transition was to reduce double taxation, increase the competitiveness of China's service industries by reducing the overall tax burden and to improve tax collection. Initially limited to transportation and modern service industries, the new VAT programme was extended nationwide in August 2013. The process of phasing out BT was completed in May 2016. The change includes new classifications of service types as illustrated in the chart following.

Industry	Previous BT rate (%)	New VAT rate (%)
Transportation service	3	11
Postal service	3	11
Basic Telecommunications service	3	11
Value-added telecommunications service	3	6
Construction service (New)	3	11
Financial service (New)	5	6
Technology and Research	5	6
IT service	5	6
Culture creativity	5	6
Logistic service	5	6
Forensic consulting	5	6
Radio and television	3-5	6
Commercial service	5	6
Life service (New)	3-5	6
Other modern service (New)	3-5	6
Intangible asset (New)	5	6
Fixed asset sales (New)	5	11

Source: Sovereign Analysis

The above VAT rates are applied to general VAT payers. As with the previous BT tax system, indirect surcharges are added to VAT and WFOEs are required to pay the local tax monthly. A rate of 3% is applied to small to scale taxpayers, which are enterprises with revenues of less than CN¥5 million per year.

4.3 TAXATION OF A REPRESENTATIVE OFFICE

ROs (except for those engaged in legal or accounting services) are not permitted to generate revenue, so their tax base for CIT and VAT is presumed on the basis of their expenses. In Shanghai and Beijing, a minimum presumed profit rate of 15% is used for the CIT calculation² but this could be determined elsewhere on a case-by-case basis. For VAT the tax is based solely on the amount of expenses incurred.

$$\text{CIT Payable} = \text{Income Amount} \times \text{Presumed Profit Rate 15\%} \times \text{CIT Rate 25\%}$$

The result of this computation is an estimated 11% tax on operation expenses. This rate excludes any surcharges that may be levied at a local level, which can raise the effective rate up to 11.8% depending on the city or district. ROs make tax filings on a quarterly basis.

² This method of calculating tax liability for ROs is applicable in Shanghai and Beijing. It is possible that the minimum presumed profit rate could be determined on a case-by-case basis.

4.4 TAX INCENTIVES

Many foreign companies, registered before 16 March 2007, enjoyed preferential CIT treatment if they were located in special economic zones or if they were involved in production-orientated businesses. Following implementation of a new income tax law from 1 January 2008, the preferential tax rates were phased out rising to the standard CIT rate of 25% by 2012.

However some tax incentives remain for certain industries and projects that are being encouraged by the government. Below are some examples:

Industries/Projects	Corporate Income Tax Rate
Certain advanced and new technology enterprises	15%
Certain small-scale enterprises with low profitability	20%
Income derived from <ul style="list-style-type: none">- Certain agriculture, forestry, animal husbandry or fishery projects- Certain investment in, or operation of, certain public infrastructure projects- Qualified environmental protection and conservation projects- Certain technology transfer projects- A non-resident enterprise	Tax exemption or reduction
Enterprises located within certain ethnic autonomous regions (subject to approval from the local government of the relevant regions).	Tax exemption or reduction

Source: Sovereign Analysis

4.5 OTHER TAXES

i. WITHHOLDING TAX

Non-resident enterprises are subject to a withholding tax at source, ranging from 6% to 16%. Instances in which withholding tax is applied include:

- Dividend payment to non-resident parent company
- Interest, rent, royalties and management fees paid to non-resident foreign enterprises
- Net capital gains from transfer of shares or equity interest in FIEs
- Payment of contracted projects and services to non-resident enterprises

The taxpayer is required to withhold the tax payable from the payment to be remitted to the non-resident enterprise and submit it to the tax authorities. China has negotiated tax treaties with several countries, which offer reduced withholding tax rates. Examples of such countries include Hong Kong, Singapore, Mauritius, Barbados, Japan, Korea and Switzerland. Foreign investors may be able to apply these reduced tax rates if the local entity is structured underneath a parent company located in one of these treaty partner countries. As from 2009, however, China has also issued a number of anti-avoidance circulars that may require the parent company in one of these jurisdictions to prove that it is a substantive business before the local China entity is permitted to enjoy the benefits of these tax treaties.

ii. STAMP DUTY

Contracts and related documents are subject to a Stamp Duty. Different tax rates, varying from 0.03% to 0.1%, apply to different types of contracts. For a purchasing and distribution contract, for example, a 0.03% tax rate is applied to the total contract amount. The Stamp Duty ticket must be attached to the contract when the contract is signed.

iii. PROPERTY TAX

Property Tax is imposed on the owners, users or custodians of houses and buildings. This is applied at the rate of either 1% to 3% of the original value with certain deductions, or 12% of the rental value. Property Tax has to be paid twice a year, in May and November.

iv. VEHICLE AND VESSEL TAX

Consumption tax is payable on the sales value of certain consumer goods. This includes 11 general items: cigarettes, alcohol, cosmetics, jewellery, precious stones, firecrackers, gasoline, diesel oil, motor vehicle tyres, motorcycles and small motor cars. The applicable tax rates range from 3% to 50% in addition to the VAT. Producers include the tax in the consumer price of their products. Retailers and wholesalers are not required to pay consumption tax when they trade goods in this category and consumption tax is fully rebated for exported goods.

v. VAT ON EXPORTS

In most, but not all, cases, the value of exported goods can be exempt from VAT and consumption tax. To gain exemption, companies must apply for a tax rebate with the relevant tax authorities after the goods have left China's territory and a number of conditions have been met:

- The exporter must have general taxpayer status
- All documentation and payments must be completed
- The goods must have a non-zero refund rate
- The rebate must be applied for prior to 15 April in the following year.

If these requirements are not met, the export will be subject to VAT as if it were a domestic sale. The formulas for calculating the rebate for a general VAT taxpaying company producing goods for export and domestic sales are as follows:

$$\begin{aligned}\text{Tax Payable} &= \text{Domestic Output} - [\text{Input VAT for Total Purchases} - \text{Non-Refundable VAT}] \\ \text{Non-refundable VAT} &= \text{Export Sales} \times [\text{VAT Rate} - \text{Refund Rate}] \\ \text{Refundable VAT} &= \text{Export Sales} \times \text{Refund Rate}\end{aligned}$$

Note that the rebate rate for certain goods can be less than the VAT rate, which means that the full amount paid as VAT on exported goods will not be refunded. To understand the process of the VAT rebate calculation, see the following example. The VAT and the rebate rate are 17%. The tax payable is negative, meaning that it will be refunded up to the amount of refundable VAT.

A	B	C	D	E	F	G
Total Purchases	Input VAT A x 17%	Domestic Sales	Export Sales	Domestic Output VAT C x 17%	Non- Refundable VAT D x (17% - 17%)	Tax Payable E - [B - F]
3,800,000	646,000	2,000,000	3,000,000	340,000	0	-306,000

Source: Sovereign Analysis

For companies engaged only in trading activities, the formula for VAT on exports is much simpler. They only need to apply for the VAT rebate. The formula for a trading company's rebate is as follows:

$$\text{Export VAT Rebate} = \text{Exported Goods Purchase Price} \times \text{Refund Rate}$$

Small-scale VAT paying companies cannot apply for export tax rebate and are required to pay VAT on exports as per the following formula:

$$\text{Tax Payable} = \text{Export Sales} \times 3\% / (1+3\%)$$

vi. VAT ON IMPORTS

VAT is also applied to imported goods, which is calculated as follows:

$$\text{Tax Payable} = \text{VAT Rate} \times [\text{Dutiable Value} + \text{Customs Duty} + \text{Consumption Tax}]$$

The dutiable value of imported goods includes the purchase price, and the transport and insurance costs. See the example below with the VAT rate of 17%, a consumption tax rate of 3% and the customs duty of 12%.

Example:

A	B	C	D
Dutiable Value	Customs Duty A x 12%	Consumption Tax [A + B] x 3%	Tax Payable (A + B + C) x 17%
3,800,000	646,000	2,000,000	3,000,000

Source: Sovereign Analysis

4.6 ANNUAL AUDIT AND ANNUAL EXAMINATION

Both ROs and FIEs are required to be audited on an annual basis. The annual audit has to be filed before the end of May of the following year and must be conducted by a firm of Certified Public Accountants (Chinese or foreign JVs) that is registered in China under Chinese regulations. An FIE must also undertake an annual examination whereby it must submit various certificates and financial documentation to local authorities for inspection.

The following chart summarises the obligations of both the RO and FIE with respect to payment dates and deadlines.

Table: Tax Filing Deadline

Entity Type	RO	FIE
Tax Registration	Within 30 Days of establishment	
Income Tax	Quarterly	Quarterly
VAT and Consumption Tax	N/A	Monthly
Housing and Vehicle Tax (Deduct Stamp Tax)	May and November	
Annual Audit and Clearance	End of May	
Annual Examination	End of June	

4.7 PROFIT REPATRIATION

FIEs may only distribute and repatriate profits back to their investors after completion of the annual audit, settlement of income tax liabilities and having made up any losses that were carried forward from previous years. An FIE must also set aside a minimum 10% of after-tax profits into a reserve fund until the accumulated reserve fund reaches 50% of the registered capital. The remaining amount is distributable profits from which the board of directors may declare dividends (less withholding tax) to the investors in proportion to their contribution to the registered capital. Once the accumulated reserve fund threshold of 50% is reached and maintained, the FIE may repatriate all profits to its home country (less withholding tax). The mandatory reserve fund ensures that a portion of the profits are re-invested into the FIE.



CASE: THE GRAFT SPIRAL

A famous European textile brand, for the sake of expediency, uses a virtual address to establish its presence in China while actually operating out of one of its distributor's offices. The registered address is therefore not a properly zoned physical office that is also its place of business. In order to obtain its general VAT taxpayer status, the firm is forced to choose between paying a bribe to its local tax official to overlook this irregularity or moving its registered address and employees to a properly zoned office space.

The company chooses to pay the bribe so that it can fulfil a customer's order that would otherwise have been lost. Unfortunately, additional requests for payoffs from the tax official follow. If the company had been properly established from the outset, it would have avoided having to make payoffs for what otherwise should have been a routine procedure.

5. EMPLOYING PERSONNEL IN CHINA

Staff employment is a key issue for companies operating in China. China's labour laws favour the employee over the employer and include very specific provisions for the employment of local and foreign staff. Companies without a registered entity in China cannot legally employ staff in China. It is therefore critical that companies entering the market understand the rules and regulations.

In addition to the basic employment requirements, signing contracts with workers, meeting wage standards and paying salaries in a timely manner, employers in China are also obliged to:

- File staff employment and dismissal notices with relevant government bureaus
- Maintain employees' personnel files – a unique Chinese document that records the academic and employment history of employees
- Withhold and pay individual income tax on behalf of employees
- Make monthly contributions to employees' social benefits and housing funds

Most of these processes are further complicated by the involvement of multiple government bureaus and copious paperwork. For FIEs, staffing their China operations may pose a considerable challenge and many choose to rely on service providers to guide them through the HR processes.

5.1 EMPLOYEE CONTRACTS

Under China's Labour Law, all companies are required to sign employment contracts with their employees. While WFOEs are allowed to sign employment contracts directly with local Chinese staff, ROs must engage authorised service providers to hire and dispatch local employees. While there is no standard contract form, the agreement should include:

- Term of contract and probation period
- Job title and description
- Labour protection and working conditions
- Compensation
- Termination conditions
- Breach of contract provisions and disciplinary rules
- Other provisions, such as training bonds, non-disclosure and non-compete agreements

5.2 EMPLOYEE PERSONNEL FILE AND STAFF HANDBOOK

Every employee in China has a personnel file detailing their education and employment history. Responsibility for maintaining this file is transferred from one employer to the next when an employee changes employer for the duration of the employment period. ROs must engage a local labour agency to maintain these files.

The staff handbook usually contains information about a company's policies and procedures. A written employee handbook gives clear guidance to employees such that any employment issues can be dealt with fairly and consistently.

5.3 BASICS OF COMPENSATION

i. BASE PAY

Base pay is paid monthly and varies from 12 to 14 months. A '13-month' pay scheme is common in China, with the additional month's pay being issued during the Spring Festival month (usually February). The minimum wage in Shanghai and Beijing is CN¥2,190 per month and CN¥1,720 per month respectively (as of 2016). New minimum wage amounts are issued each year.

ii. INCENTIVE PAY

Incentives can be paid monthly, quarterly or annually and are increasingly tied to individual performance. Many organisations and Chinese employees welcome the concept of performance-based variable pay. Success and monetary reward through performance differentiation are concepts that employees appreciate, especially in China's Tier 1 cities.

Some of the incentives in use include: individual performance plans, team performance plans, cash profit-sharing plans (payouts based on organisational profitability), comprehensive performance plans (awards based on the performance of the company, team and individuals), sales bonus plans, sales commissions and special recognition awards.

iii. ALLOWANCES

Personal allowances are a unique and very important form of compensation in China. Although FIEs are not obliged to provide them, allowances are often regarded as more valuable in the Chinese culture than the cash equivalent. Highly valued cash allowances include transport, meals, clothing and child care allowances.

iv. SOCIAL BENEFITS

Social benefits for Chinese employees can be classified either as mandatory or supplemental. Mandatory benefits are contributed to by both employers and employees as stipulated by China Labour Law and comprise a significant portion of the total compensation. According to the law, these benefits are also required for foreign employees. In most cities this has not been implemented, but social benefits are mandatory for foreigners in Beijing, except the public housing fund, while they remain optional in Shanghai.

Each benefit has its own percentage that is applied to an employees' gross salary. In addition, for most cities in China a minimum and maximum base range is set and, for gross salaries outside the base range, the contribution percentage is applied to the minimum or maximum base depending on which side the gross salary amount falls. Each city and region sets its own minimum and maximum base amounts, and applies percentages for each benefit. These are subject to change each year.

The following chart is current as of 1 June 2017 for Beijing and Shanghai.

Social Benefits	Beijing		Shanghai	
	By Employer	By Employee	By Employer	By Employee
Pension Insurance	19%	8%	20%	8%
Unemployment Insurance	0.8%	0.2%	0.5%	0.5%
Medical Insurance	10%	2% - CN¥3	9.5%	2%
Workplace Insurance	0.4%	-	0.2%-1.9%	-
Maternity Insurance	0.8%	-	1%	-
Public housing fund	12%	12%	7%	7%
Total	43%	22.2% + CN¥3	38.2% - 39.9%	17.5%
IT service	CN¥23,118		CN¥19,512	
Culture creativity	CN¥3,082	*CN¥4,624	CN¥3,902	
Logistic service	CN¥7,706		CN¥6,504	

*percentages based on gross salary

Source: Sovereign Analysis

Based on the percentages and minimum/maximum base range, the net salary of a Chinese employee, including social benefits contribution, is then computed as:

$$\text{Net Salary} = \text{Gross Salary} - \text{Social Benefits (By Employee)} - \text{Deductible} - \text{IIT (Individual Income Tax)}$$

A detailed sample calculation is shown below.

5.4 SAMPLE CALCULATION OF SOCIAL BENEFITS, INCOME TAX AND NET SALARY

The following table illustrates a sample calculation of social benefits, income tax and net salary for an employee earning a gross salary of CN¥5,000 in Shanghai. This example demonstrates that the total amount payable by the employer can be significantly higher than the gross salary (in this case 44% above the agreed upon gross salary).

Gross Salary	Company Expenses								
	Social Benefits						Housing Fund	Total	Total Expenses
	Pension	Medical Insurance	Unemployment Insurance	Maternity Insurance	Workplace Insurance	Sub-Total			
	20%	9.5%	0.5%	1%	0.2% - 1.9%	31.2% - 32.9%	7%	38.2% - 39.9%	
1,000	475	25	50	10-95	31.2% - 32.9%	350	1,910 - 1995		
5,000	Employee Expenses								
	Social Benefits				Housing Fund	Income Before Tax	Individual Income Tax ⁴	Net Salary	
	Pension	Medical Insurance	Unemployment Insurance	Sub-Total					
	8%	2%	0.5%	10.5%	7%				
400	100	25	525	350	4,125	18.75			

Source: Sovereign Analysis

4) Includes Standard CN¥3,500 deduction and quick deduction

Employer's and Employee's Share of Social Benefit and ITT

Components	Total Expense	Example	7,045
Employer's Share of Social Benefits		▲ add 2,045 (5,000*40.9%) max	
Employee's Share of Social Benefits	Gross Salary	↓ subtract 875 (5,00*17.5%)	5,000
Employee's Taxes		↓ subtract 18.75	
Net Salary	Net Salary		4,106.25
			0

DISABILITY FUND

In addition to employee social benefits contributions, cities in China also require companies to contribute to a disability fund if they do not employ a certain proportion of disabled workers – 1.6% for Shanghai and 1.7% for Beijing. The formulas for Shanghai and Beijing are as follows:

Shanghai Disability Fund Contribution =
 [(Number of Total Employees x 1.6%) – Number of Disabled Employees] x Previous Year's Average Annual Salary⁵ of the Company (this is paid yearly, October)

Beijing Disability Fund Contribution =
 [(Number of Total Employees x 1.7%) – Number of Disabled Employees] x 60% of Previous Year's Average Annual Salary in Beijing (this is paid yearly, July)

5.5 TERMINATING AN EMPLOYMENT RELATIONSHIP AND SEVERANCE PAYMENTS

China's Labour Law requires companies to pay severance unless the employer dismisses its staff for a specifically defined cause. In other situations, the employer will be required to give 30-days' notice to the employee and/or pay compensation as stipulated by the provincial government. The Labour Law also requires companies to consult with the appropriate labour union if they wish to reduce their workforce.

Specifically defined causes for dismissal include those where it can be proved that an employee has:

- Been unable to satisfy the conditions of employment during the probation period
- Materially breached an employer's specified rules and regulations
- Caused substantial damage to an employer through serious negligence of duty
- Been unable to complete conflicting tasks given by two different employers

A severance payment is not required if an employee fails to agree to a renewed contract that contains the same or better conditions than those stipulated in the current contract.

Where severance payments are required, they are generally equivalent to one month of salary per year of employment with the company. For employment periods of less than six months, half of one month's salary would be paid as severance.

5.6 CONSEQUENCES OF BREACHING THE LABOUR CONTRACT LAW

Companies should not breach the Labour Contract Law or take advantage of their employees in any way for short-term gains. Even if an employee does not make a complaint during the period of employment, employers remain liable for damages up to one year after an employee has left a company.

Foreign companies should note that the labour rights of employees are well publicised and understood in China, and costly litigation or settlements are increasing in frequency. HR departments should keep up-to-date with the Labour Contract Law and, if any changes to the working environment or duties are deemed necessary, or a dismissal is required, should ensure that everything is clarified in writing and signed by an employee in advance of action being taken.

China's Labour Contract Law applies to foreign workers only when they are directly employed by an entity registered in China, including both domestic Chinese companies and FIEs. The law does not apply to foreign workers working in China but directly employed by an overseas company.

5.7 CHINA'S 'LABOUR DISPATCH' RULES

'Interim Regulations on Labour Dispatch' were issued by China's Ministry of Human Resources and Social Security (MOHRSS) and came into force on 1 March 2014. It was the first comprehensive labour dispatch regulation issued at ministerial level and introduced several changes to the current rules that have an impact on FIEs.

Under the Interim Regulations, labour dispatching arrangements apply to the following types of position:

- **Temporary:** A position with a duration of less than six months
- **Auxiliary:** A position that provides auxiliary services to the main or core business of the employer; and
- **Replaceable:** A position that can be performed by a dispatched employee during the period when a permanent employee is away from work for study, vacation or other reasons.

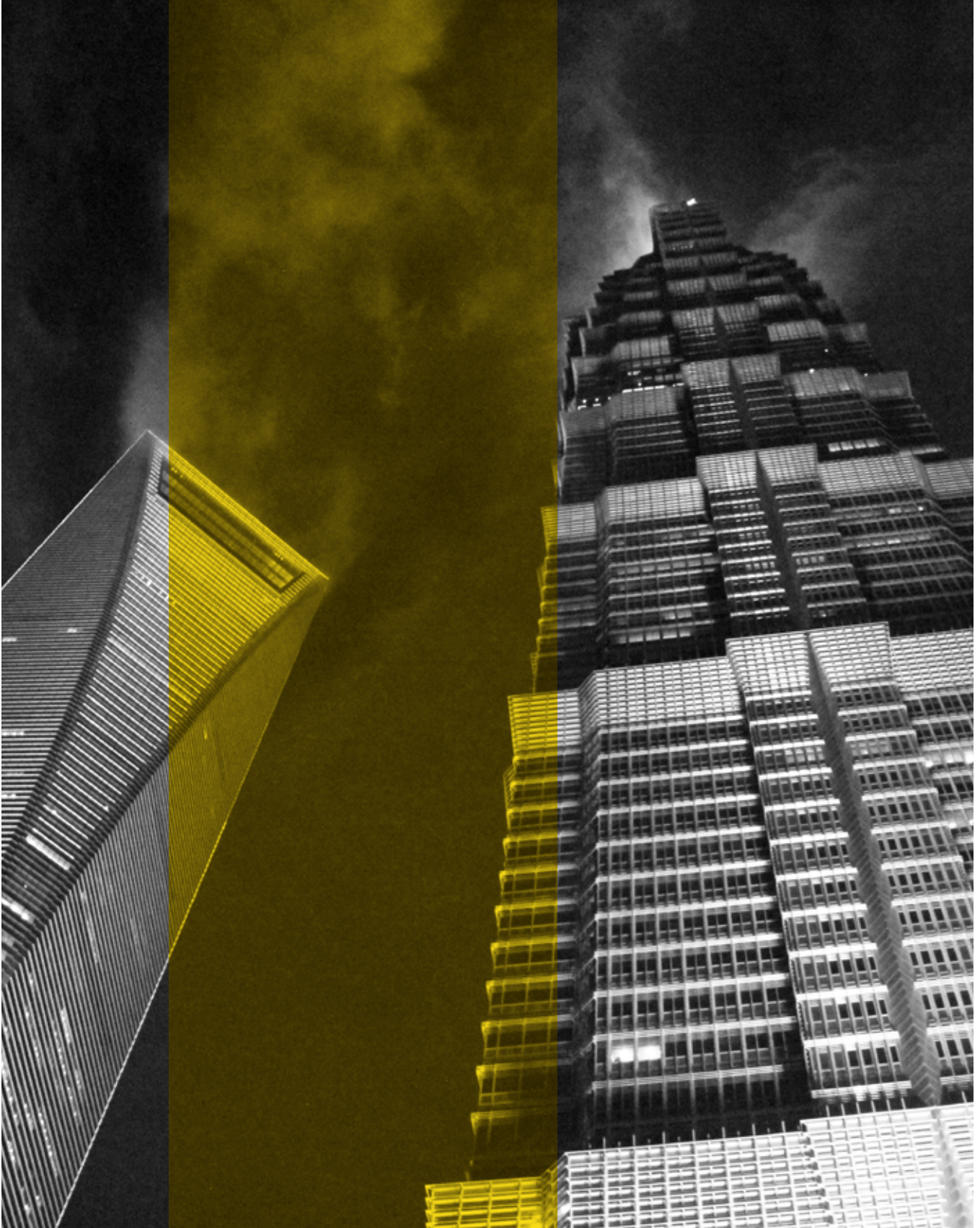
A dispatch contract must state the specific type of position and the number of dispatched employees should not exceed 10% of the total number of employees, including both regular and dispatched employees. These rules apply to all the FIEs except ROs, which are not subject to the rules.

The key rules that FIEs should note are:

- **Contract Arrangement:** A contract signed between the labour dispatching company and the dispatched employee should have a fixed employment term of at least two years. With the consent of the dispatched employee, the dispatching company may introduce a probationary employment period in the contract. Dispatching companies are only allowed to arrange a probationary period once with each dispatching employee.
- **"Equal Pay for Equal Work":** According to the Interim Regulations, the principle of "equal pay for equal work" applies to all labour dispatching agreements, such that dispatched employees are entitled to the same remuneration levels as those enjoyed by an employer's direct-hire employees holding similar positions. This includes overtime salaries and bonuses. In the absence of similar direct-hire employees, local market rate salaries should be used to determine the remuneration payable to dispatched employees.
- **Termination of Labour Contracts:** Upon termination of a contract, dispatched employees are entitled to a 30-day notice period (or three days if still within a probationary period). Under the Interim Regulations, an employer may return dispatched staff to the dispatching company due to major changes in objective circumstances i.e financial difficulties, dissolution of its host entity or discontinuation of its operations. A labour dispatching company can only terminate an employee's contract if the employee refuses to agree to a new dispatch arrangement that provides equal or better conditions.

Dispatched employees are entitled to local social insurance rates and standards. The local branch of the dispatching company will be responsible for paying the insurance. In the absence of a local branch, the employer must pay the social insurance on behalf of the labour dispatching company.

It is important for FIEs to comply fully with the rules under the Interim Regulations. In the event of a breach of the rules, which must be remedied within a time frame specified by the relevant labour bureau, foreign employers may be liable for fines between CN¥5,000 and CN¥10,000 per dispatched employee.



6. INDIVIDUAL INCOME TAX (IIT) IN CHINA

Individuals residing in China are subject to the country's individual income tax (IIT), which is generally withheld from wages by employers and paid to the tax authorities on a monthly basis. Factors that affect IIT liability in China include: whether the employee is local or foreign, whether the income is local or foreign, the type of legal entity the employee is working for and the position the employee holds. This guide focuses on the taxation of foreign and local employees' income and how it is applied.

6.1 LOCAL EMPLOYEES

Local employees are taxed on the basis of the balance of their monthly income after deducting their social benefits contribution, a standard deduction of CN¥3,500, and then applying the progressive tax rates as shown in the table below. The employer is obliged to withhold the full tax amount and submit the taxes to the appropriate Chinese authorities on behalf of their employees.

Taxable Monthly Income (CN¥)	Tax Rate	Quick Deduction
Less than 1,500	3%	0
1,501 – 4,500	10%	105
4,501 – 9,000	20%	555
9,001 – 35,000	25%	1,005
35,001 – 55,000	30%	2,755
55,001 – 80,000	35%	5,505
Over 80,000	45%	13,505

Source: Sovereign Analysis

Taxable Income = Gross Salary – Social Benefits – CN¥3,500 IIT = Taxable Income x Tax Rate – Quick Deduction

Net Salary = Gross Salary – Social Benefits – IIT

A detailed sample calculation of an employee's social benefits, income tax and net salary can be found on page 36.

6.2 FOREIGN EMPLOYEES

The IIT liability of foreign individuals in China depends on the individual's duration of stay in China and their source of income.

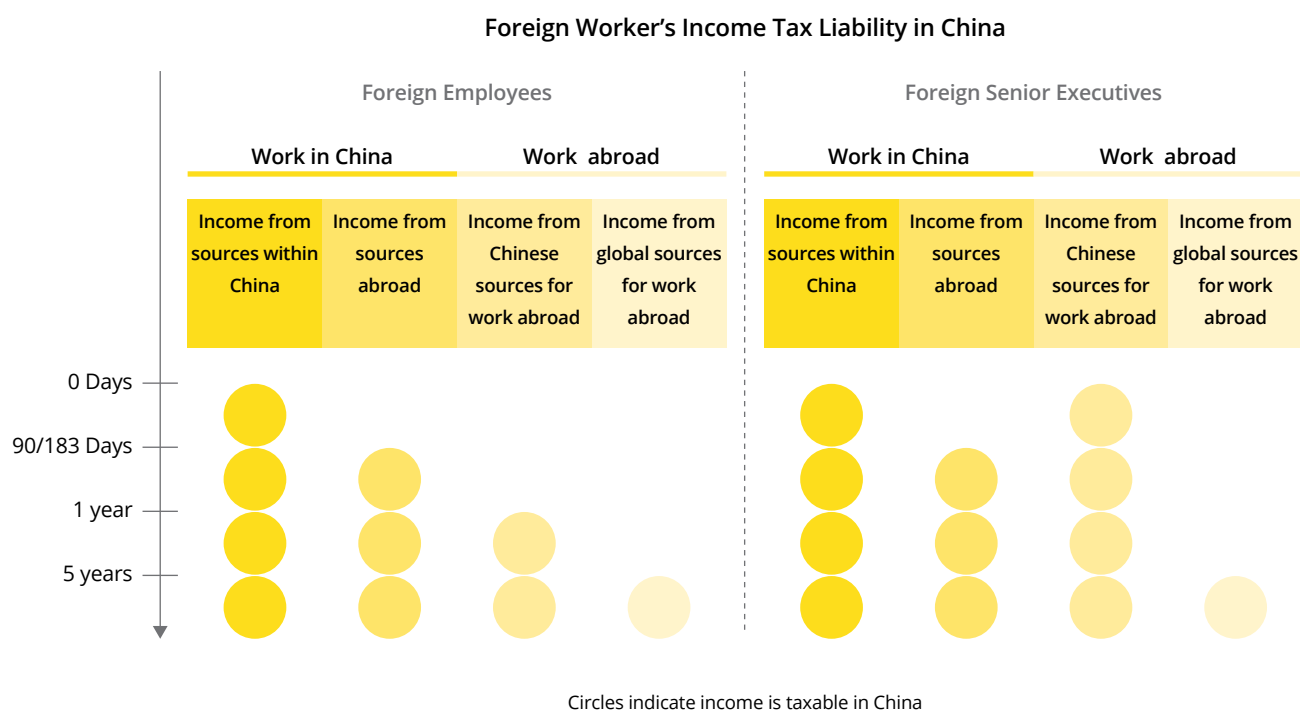
A non-resident individual who has worked in China continuously or cumulatively for fewer than 90 days in a tax year is exempted from IIT on income paid by a foreign employer outside of China. This means that the individual is only subject to IIT for income they received from Chinese domestic institutions, entities and individuals for work done in China.

An individual who has resided in China for more than 90 days but less than one year during the tax year is subject to IIT on all China-sourced income, which includes income paid by both Chinese and overseas entities for their work in China. Income earned while working overseas in the tax year is not Chinese IIT taxable. If there is a double taxation treaty between a foreign country and China, the 90 days may be extended to 183 days, depending on the relevant treaty.

The IIT Law stipulates that a resident or non-resident individual residing in China for one tax year or more is subject to Chinese IIT for both China-sourced income and non-China sourced income. The Chinese tax year follows the calendar year and “residing in China for one year” is defined as residing in China for 365 days in a tax year. However, a non-resident who has taken temporary absences from China for less than 30 days continuously or 90 days in total in a tax year will be deemed to have resided in China for 365 days of the tax year. Days on which the individual enters or leaves China are deemed to be a full day in determining his/her duration of stay in China.

A foreign individual who has resided in China for more than five years continuously may face IIT liabilities identical to those of a resident individual of China, depending on the duration of their residency in China starting from the sixth tax year. If a foreign individual resides in China for one year in the sixth or any following single year, they will be deemed to be a resident individual under IIT and taxable on income received globally for that specific tax year; if the individual resides in China for less than one year in the sixth or any following single year, they are subject to IIT on only China-sourced income, and the one-year rule applies. The five-year threshold will be reset if the individual resides in China for less than 90 days in any single tax year starting from the sixth year, in which case the 90-day rule will apply for that tax year.

The 90-day and one-year rules do not apply to foreign individuals hired as directors or other senior executives of enterprises located in China. These foreign individuals are liable for their full income derived from Chinese sources from the first day in the country. For better understanding of taxable income for longer periods of stay and for senior officials compared to ordinary employees, please see the chart below.



One special situation needs to be mentioned. The salary of a Chief Representative of an RO, which is issued by the parent company abroad, is taxed on a pro-rated basis. Chief Representatives must apply for part-time status, which allows them to pay taxes on their income from abroad only for the time spent in China. This rule does not apply for senior officials of WFOEs because these are registered as Chinese companies and pay their employees from within China.

i. REGISTRATION PROCEDURES

If the employee is liable for China tax filing, the following procedures for registration apply and the following documents are required:

- Original salary certificate from overseas employer
- Copy of employment contract
- Copy of all pages of passport

If the employer has a 'permanent establishment' in China then the employee's work permit, and the employer's tax registration certificate and business licence are required.

ii. TAX CALCULATION

Having established which incomes are subject to Chinese IIT, the calculation differs only slightly from that described for local employees. The same tax rates and tax brackets apply for the incomes for expatriates working in China. However, foreign employees deduct an amount of CN¥4,800 instead of CN¥3,500 before calculating the tax payable according to the formula on page 36 and, depending on the city in which the employee is working, social benefits' contribution may or may not be needed. Some allowances and benefits paid by the employer are not taxable³. These include allowances for home leave (only applicable twice a year), language training, children's education, housing rental, moving costs, food, laundry and dry cleaning, as well as business trip expenses.

6.3 ANNUAL INCOME TAX FILING

IIT self-declaration in China is intended to cultivate an individual taxpayers' awareness of their tax responsibilities. China's tax regulations require taxpayers who fall under any of the following five categories to self-declare their annual income:

1. With annual taxable income of CN¥120,000 or more
2. Receiving salary and remuneration from two or more employers in China
3. Generating income abroad
4. Generating taxable income without withholding agent
5. Other cases as specified by the State Council

Category 1 taxpayers must declare taxes to relevant authorities within three months of the end of a tax year (i.e. between 1 January and 31 March each year). Categories 2, 3 and 4 are required to make a tax declaration upon receipt of the income.

³ This includes allowances for home leave (only applicable twice a year), language training, children's education, housing rental, moving, food, laundry and dry cleaning, and business trip expenses.

6.4 ANNUAL INCOME TAX FILING PROCEDURES

There are several possible modes of tax declaration including online, postal or direct physical delivery to the local tax authorities. Taxpayers may also entrust intermediary agencies or other qualified persons for tax agency services with their tax declarations.

When computing the annual income, the individual must take into consideration the following 11 components:

- Salary and compensation
- Income from production and operation by individually-owned business
- Income from contract operation and operation under lease of enterprises or social service providers partly or wholly funded by state assets
- Compensation for labour services
- Author's remuneration
- Royalties
- Interest, dividends and bonus
- Income from lease of property
- Income from transfer of property
- Incidental income
- Other income specified by finance department under the State Council

A severance payment is not required if an employee fails to agree to a renewed contract that contains the same or better conditions than those stipulated in the current contract.

Where severance payments are required, they are generally equivalent to one month of salary per year of employment with the company. For employment periods of less than six months, half of one month's salary would be paid as severance.

As stated in earlier sections, taxpayers are allowed deductions, such as social insurance contributions and a general deduction amount of CN¥3,500 for locals and CN¥4,800 for foreigners, when calculating their taxable income. The regulations also allow certain tax exemptions, which include:

- Particular rewards in respect to science, education, technology and culture
- Interest of treasury and financial bonds issued by China
- Specific academic subsidies or allowances
- Welfare and relief for the disabled

If an individual fails to declare his or her taxes within the specified three-month period, the local authorities may provide an extended deadline but may also impose a penalty for late payment. If the taxpayer fails to make a tax declaration again, or fails to pay or underpays the tax payable, the taxpayer will be held liable for the amount of tax payable together with a possible surcharge.

6.5 REPATRIATION OF SALARY PAID IN CN¥ IN CHINA

Foreign employees may remit their total monthly net salary back to their home country. In order to convert their CN¥ salary into foreign currency, they will be required to present their local bank with proof of income, proof of tax payment, their Alien Employment Permit, as well as other documents.

7. PROTECTING INTELLECTUAL PROPERTY (IP) IN CHINA

Contributed by Harris Bricken Law Firm

China is often perceived as a lawless frontier where anything goes when it comes to intellectual property (IP)⁴. This is somewhat misleading. China has excellent laws that offer a great deal of protection for intellectual property. What it lacks is consistent, effective enforcement of those laws.

Many of China's IP laws are still relatively new. Until recently Chinese companies were not creating much IP, and neither the Chinese government nor Chinese companies saw much value in protecting it. However, as a condition of its accession to the World Trade Organisation in 2001, China was required to harmonise its IP laws with those of Western countries. Although a law can be changed in a single day, understanding and proper enforcement often takes longer.

To be clear, inconsistent enforcement is not the same as non-existent enforcement. Companies that formally register their IP with the appropriate authorities, ensure their contracts with Chinese suppliers are well drafted and perform proper due diligence before selecting their Chinese partners have a fighting chance of preventing third-party infringement. Companies that do none of the above have no one to blame but themselves.

7.1 LEGAL PROTECTION

i. TRADEMARKS

China employs a 'first-to-file' system for trademark registration and affords no protection to unregistered trademarks⁵. This can come as a shock to companies that are used to the Anglo-American system, under which a company gains common law rights by virtue of using a brand in commerce. In China, a third party can both register 'your' trademark and prevent you from using it without selling a single product themselves. They may even be able to prevent you from using 'your' trademark in China if all you are doing in China is manufacturing products for export. Such trademark 'squatting' is fairly common and, when it occurs, the options are not particularly appealing: pay a licensing fee to the trademark squatter, buy the trademark outright or change your trademark.

Companies doing business in China should register as a trademark any 'distinctive phrase' or 'logo' used on their products or their packaging, or in the marketing or sale of services. Companies that sell products or services in China should also select and register a Chinese-language mark. No matter how well-known or simple your English-language mark may be, if you don't consciously choose a parallel Chinese-language trademark, then Chinese consumers and retailers will come up with one on their own. And you'll have ceded to someone else the opportunity to name and own your product.

Even companies that aren't doing business in China should consider registering their trademarks in China as a preventative measure. China does not require a trademark owner to prove use in commerce (unless challenged), with the result that a canny trademark owner can craft a large, wide-ranging trademark portfolio in China that arguably offers more protection than in the West. Also, having a trademark registration in China is always helpful (and sometimes necessary) when attempting to remove infringing goods from e-commerce sites like Taobao.

The first mover advantage is considerable and the risks associated with inaction can be high. If you plan to use a brand name in China, register it yourself before someone else beats you to it. It takes approximately 15 months for China's Trademark Office (CMTO) to issue a trademark if everything goes smoothly. While your application is pending, no one can stop you from using the mark, but neither can you legally stop anyone else from using it. The main caveat is that you should not apply too early; a trademark that is not used in commerce for a three-year period is at risk of cancellation.

⁴ There is no single definition of intellectual property, but it is generally understood as intangible property resulting from creativity or invention that is protectable either as a trade secret or via copyright, trademark or patent.

⁵ The one exception to this rule is for internationally well-known trademarks, but only brands with name recognition on the level of Starbucks and Nike qualify as 'well-known'. Even Starbucks had to fight a long, costly court battle to prove it was a well-known brand. By contrast, Chinese courts have deemed Dell Computer, Hermès and Chivas Regal not to be well known.

One important note regarding the above: China's new Trademark Law, which came into effect on 1 May 2014, introduced several changes to trademark protection in China. In theory, these changes have made it easier to (among other things) challenge trademark squatters and improve the efficiency and speed of filing, appealing and opposing trademarks. But the devil is in the detail and we haven't seen any improvements to date in respect of either the efficiency or quality of the CTMO's decisions.

ii. PATENTS

Like every other country in the world, China is a 'first-to-file' country for patent registrations. China is also a party to the Paris Convention, which means that a company that first files a patent application in another Paris Convention signatory nation (i.e. nearly every developed and developing nation in the world) has 12 months to file a patent application in China and 'backdate' its application to the date of the original application.⁶

Patent law is highly technical and is not conducive to distillation into a few sentences, except for the following: any company that plans to sell or manufacture patented products in China should register its patent(s) there⁷; and design patents are becoming increasingly important and should be considered an essential part of any manufacturer's IP portfolio.

iii. COPYRIGHT

China protects copyrighted material in much the same way as the Western world. This tends to surprise visitors to China, who have no trouble finding pirated movies, games and albums online. Again, the problem is not the lack of laws, but the lack of enforcement. But things are getting better on this front. Many websites are actively engaged in anti-infringement efforts, not least because the big Chinese streaming sites have started paying real money for the rights to stream content, which makes them suddenly very interested in taking down pirated content.

A creative work first published in another country (the US, for example) automatically gains copyright protection in China upon its creation. No formal registration is required; however, just as in the US, it is advisable to register copyrights in China, because doing so provides better evidence of ownership and stronger enforcement remedies. A toy company worried about a Chinese company manufacturing copycat dolls for export should register its copyrights in China, because doing so will allow the copycat goods to be seized at customs. A film company worried that a Chinese company will remake its movie should copyright the script, because doing so would allow the true owner to block a copycat movie.⁸

iv. CUSTOMS

Simply registering your trademarks, patents or copyrights will not limit the spread of counterfeit goods. Registration merely gives you the legal capacity to enforce your rights to that IP, and should therefore be seen as just one of the pieces in an overall strategy.

For any company that is concerned about counterfeit goods coming from China, the next step after registering IP should be registering that IP with China Customs. This is not a legal requirement but a practical one. Customs officials have discretion to check every outgoing shipment for trademark, copyright, and patent infringement, but in reality they only check against the Customs' database. No separate registration with Customs therefore means no enforcement by Customs.

If you register your mark with China Customs, it will contact you if it discovers a shipment of potentially infringing goods. At that point you have three working days to request seizure of the goods. Assuming you request seizure (and post a bond), Customs will inspect the goods. If Customs subsequently concludes the goods are infringing, it will invariably either donate the goods to charity (if the infringing mark can be removed) or destroy the goods entirely. The cost of destruction and of storing the goods during the inspection process will be deducted from your bond.

Registration with China Customs takes approximately five months and can only be done after your trademark, patent or copyright is registered. In other words, the sooner you start the process of registering your IP, the sooner Chinese Customs could be helping to stop counterfeit goods from being exported from China.

⁶ As of March 16, 2013, the United States (which had been the last holdout) became a "first to file" country with respect to patent registration.

⁷ The Paris Convention grants the same rights to trademark holders, except they only have 6 months to file a trademark application.

⁸ Although in theory, the local State Administration of Radio, Film and Television (SARFT) would block such a film before it even began, because every script must be submitted to SARFT for approval prior to filming.

7.2 CONTRACTUAL PROTECTION

i. NON-DISCLOSURE AGREEMENTS

Any foreign company entering the Chinese market should have a written contract with its Chinese counterpart that addresses IP protection. The most familiar example of such a contract is the non-disclosure agreement (NDA) that many companies require prospective suppliers, designers or employees to sign before sharing sensitive or secret information.

However, a typical 'off the shelf' NDA used by many foreign companies is insufficient and often completely ineffective in China. Foreign companies should instead insist that their Chinese partners sign non-disclosure/non-use/non-circumvent agreements (often called NNNs) specially crafted for use in China, along the following lines:

- **Non-disclosure Agreements:** Non-disclosure to an unrelated third party in China is fairly uncommon. The bigger risk is disclosure to a related third party. Many Chinese businesses have multiple subsidiaries, and manufacturing is often done through a large network of sub-contractors. Chinese companies are quite relaxed about passing around information within this network. A good NDA must therefore focus on control of information within a network that the Chinese manufacturer itself may not consider as falling within the scope of a non-disclosure requirement.
- **Non-use Agreements:** Often, a foreign company's biggest concern is that a Chinese manufacturer will use its IP to compete against it. For this purpose a non-use agreement is required. A good non-use agreement focuses on two issues. First, the agreement identifies the applicable IP of the foreign company and authorises the Chinese manufacturer to use that IP solely to manufacture the product for the foreign company. Second, the agreement requires the manufacturer to agree not to manufacture the product or any similar product under any circumstances, other than for the foreign company. This second provision is the most important because it prevents the Chinese manufacturer from manufacturing a similar product under its own trademark. Many companies have products that are only protectable as trade secrets because there is nothing to patent or copyright. A non-use agreement is the only way to prevent copycat manufacturing.
- **Non-circumvention Agreements:** A foreign company does not want a Chinese manufacturer to undermine it by selling the product directly to its existing or future customers. This is called circumvention and it is extremely common in China. A non-circumvention agreement is required to avoid getting 'cut out' in this way.

i. ENFORCEABILITY

Even the best agreement is of no use unless it can be enforced in China, another fatal flaw of most off-the-shelf NDA agreements. Any agreement governed by non-Chinese law with enforcement by litigation or arbitration outside of China is almost always useless. US courts rarely have jurisdiction over Chinese companies and therefore a judgment from a US court is of no value. Similarly, arbitration outside of China is expensive and slow and a non-Chinese arbitral body cannot impose an injunctive remedy in China.

Foreign companies can take several steps to increase their chances of having an NNN agreement that will actually be enforced in China. The contract, which must be accurately translated into the Chinese language, should provide for enforcement through litigation in a Chinese court or through arbitration with a recognised Chinese arbitral body like the China International Economic and Trade Arbitration Commission (CIETAC). The contract should also identify specific monetary damages that will be awarded in the case of a breach. Unlike common law jurisdictions, China encourages specific contract damage provisions because they simplify the court's work. Moreover, specific damage amounts make the cost of a breach clear to the Chinese manufacturer and will go a long way towards discouraging a breach. This assists in quick and effective dispute resolution, which is much to the advantage of the damaged party.

Ultimately, well-crafted NNNs are effective in China for three reasons. First, they help to weed out those Chinese companies that intend to steal foreign companies' IP. Such companies are happy to sign a poorly drafted, unenforceable agreement, but are not so eager to sign a contract that could be used against them. Second, legitimate Chinese companies do not like to be sued any more than companies in the rest of the world, and will seek to avoid a lawsuit when the odds are stacked against them. Third, Chinese courts are increasingly familiar with NNNs and will generally enforce them.

7.3 PRACTICAL PROTECTION

Foreign companies entering China should not leave common sense at the border. When selecting a Chinese company to work with, they should exercise the same due diligence (if not more) as in their home country. Look up the Chinese company on the Internet. Find out what sort of reputation they have. Contact other companies that have previously worked with a Chinese company. Visit the factory or the offices, or both. Meet with the Chinese company's executives and managers. Do a corporate records' search. If things don't stack up, it's probably because there's something amiss.

Foreign companies should also institute a clear and consistent policy for sharing confidential information, and insist that the Chinese company does the same. For instance, mark all confidential information as secret. Ensure the Chinese company acknowledge receipt, in writing, of all such information. Strictly limit access to such information to people who need to use it. Confidential information that is treated in the same way as non-confidential information ceases to be confidential. And in most cases involving theft of trade secrets, the culprit is an employee.

Finally, when you have entered the Chinese market, continue to monitor your IP closely. Pay attention to what your Chinese partners are doing, the manner in which your IP is being used and the actions of your competitors. You cannot rely on your Chinese partners to do this work. Like every other company in the world, your Chinese partner has its own agenda and that agenda may not coincide with yours.

CASE: THE CASE OF THE SHANZHAI IP AGENT

A North American food company that had become quite successful selling its food product in China learned that a company in Beijing was selling counterfeits of its product. Believing it had registered its trademark in China, the North American company began preparing to sue the Beijing company. In the process of doing so, the North American company learned that while it had retained and paid a purported trademark agent to file a trademark, it had never received a trademark certificate and the 'trademark agent' had in fact taken their money and done nothing.

Without a registered trademark in China, the North American company was powerless to stop the counterfeiter. Its only option was to register its brand name as a trademark, wait more than a year until the trademark proceeded to registration, and then send out a cease and desist letter.

The best way to protect your brand name in China has not changed: register the brand name as a China trademark at the earliest opportunity, so that you already have the registered trademark in hand if you need to defend it. And don't be afraid to ask for references. Reputable service providers will not hesitate to give them.



8. SOVEREIGN GLOBAL OFFICES

Bahamas

Tel: +1 242 322 5444
bh@SovereignGroup.com

Bahrain

Tel: +973 17 1515 71
bahrain@SovereignGroup.com

British Virgin Islands

Tel: +1 284 495 3232
bvi@SovereignGroup.com

Cayman Islands

Tel: +1 949 7555
cay@SovereignGroup.com

China, Beijing

Tel: +86 10 6587 6947
china@SovereignGroup.com

China, Shanghai

Tel: +86 21 5211 0068
china@SovereignGroup.com

Curaçao

Tel: +599 9 465 2698
cu@SovereignGroup.com

Cyprus

Tel: +357 25 733 440
cy@SovereignGroup.com

Dubai

Tel: +971 4 270 3400
dubai@SovereignGroup.com

Gibraltar

Tel: +350 200 76173
gib@SovereignGroup.com

RegisterAnAircraft.com

Tel: +350 200 76173
rana@SovereignGroup.com

RegisterAYacht.com

Tel: +350 200 51870
ray@SovereignGroup.com

Sovereign Accounting Services (Gibraltar) Limited

Tel: +350 200 48669
sasgib@SovereignGroup.com

Sovereign Asset Management Limited

Tel: +350 200 41054
sam@SovereignGroup.com

Sovereign InsuranceServices Limited

Tel: +350 200 52908
sis@SovereignGroup.com

Guernsey

Tel: +44 1481 729 965
ci@SovereignGroup.com

Hong Kong

Tel: +852 2542 1177
hk@SovereignGroup.com

Isle of Man

Tel: +44 1624 699 800
iom@SovereignGroup.com

Malta

Tel: +356 21 228 411
ml@SovereignGroup.com

Mauritius

Tel: +230 244 3210
mu@SovereignGroup.com

Portugal

Tel: +351 282 340 480
port@SovereignGroup.com

Seychelles

Tel: +248 4321 000
sc@SovereignGroup.com

Singapore

Tel: +65 6222 3209
sg@SovereignGroup.com

South Africa, Cape Town

Tel: +27 21 418 2170
sact@SovereignGroup.com

South Africa, Johannesburg

Tel: +27 11 305 7480
sajb@SovereignGroup.com

Switzerland

Tel: +41 21 971 1485
ch@SovereignGroup.com

Turks & Caicos Islands

Tel: +1 649 946 2050
tci@SovereignGroup.com

United Kingdom, Channel Islands

Tel: +44 151 328 1777
ukpensions@
SovereignGroup.com

United Kingdom, London

Tel: +44 20 7389 0555
uk@SovereignGroup.com



SHANGHAI OFFICE

Suite 805, Tower A, Guangqi Culture Plaza
2899 Xietu Road, Xuhui District
Shanghai, China 200030
Tel: +86 21 5211 0068
Fax: +86 21 5211 0069

BEIJING OFFICE

No.1440,14/F, Tower A
Pacific Century Place
No.2A North Workers Stadium Road
Chaoyang District
Beijing, China 100027
Tel: +86 10 6587 6947
Fax: +86 10 6582 0251

china@SovereignGroup.com
www.SovereignGroup.com/China